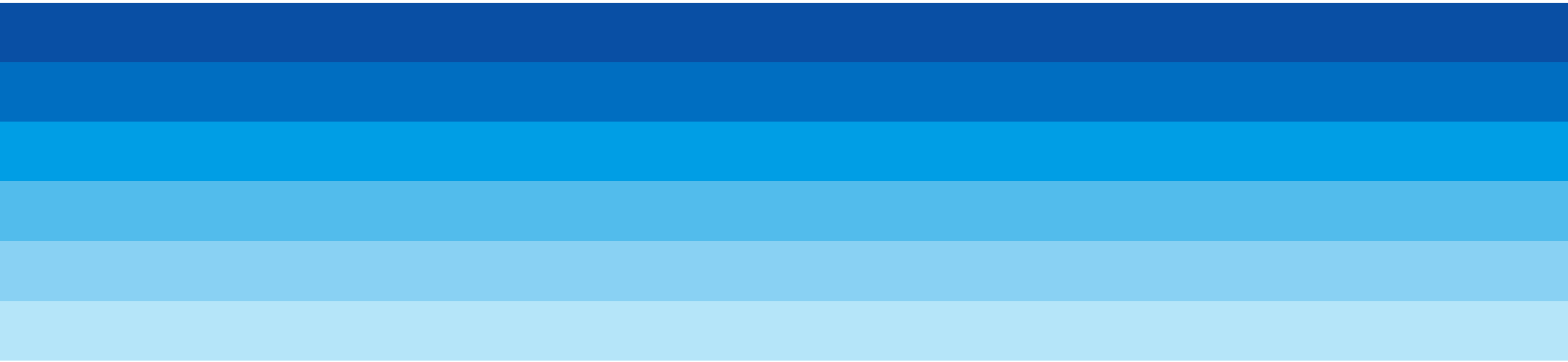


Europe Outlook

August 2014



Index

Section 1

The global economy keeps growing

Section 2

The drivers of growth: greater contribution of monetary policy

Section 3

Forecasts: the slow recovery in the eurozone continues

Section 4

Some imbalances have been corrected, but the growth potential is reduced

Annex

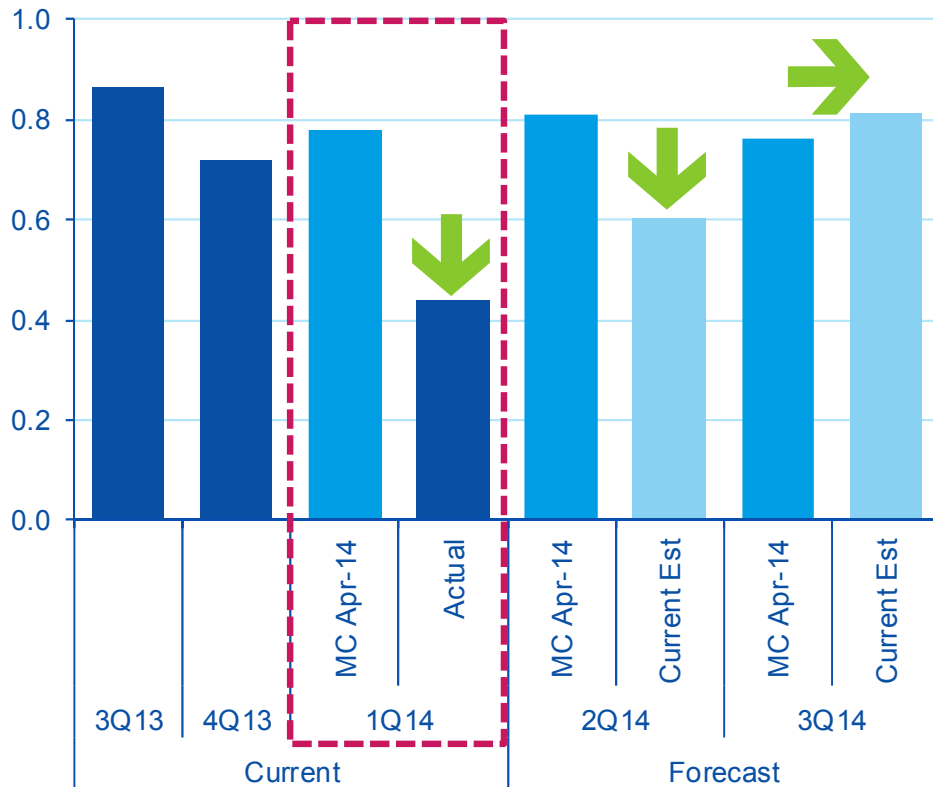
Country breakdown

Global outlook: global growth will gain pace after its slow down in the first half of 2014

Global growth based on BBVA-GAIN

(QoQ %)

Source: BBVA Research

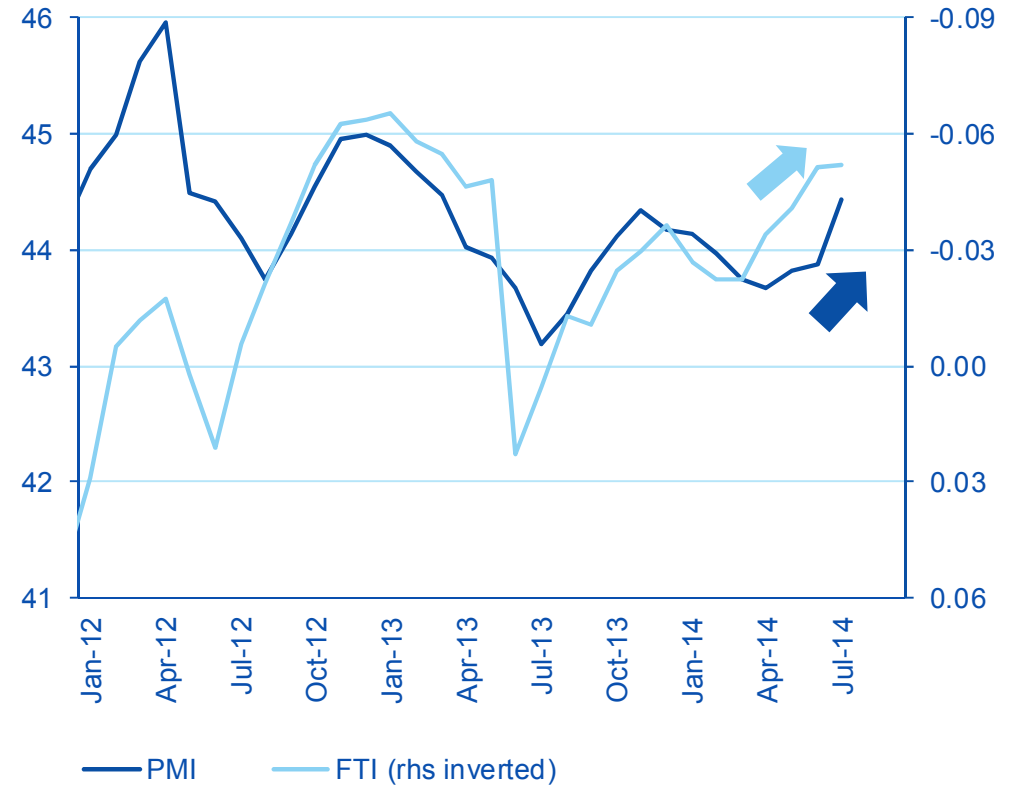


Confidence and stress in markets

PMI and BBVA's Financial Stress Index

Source: BBVA Research and Haver

Emerging markets



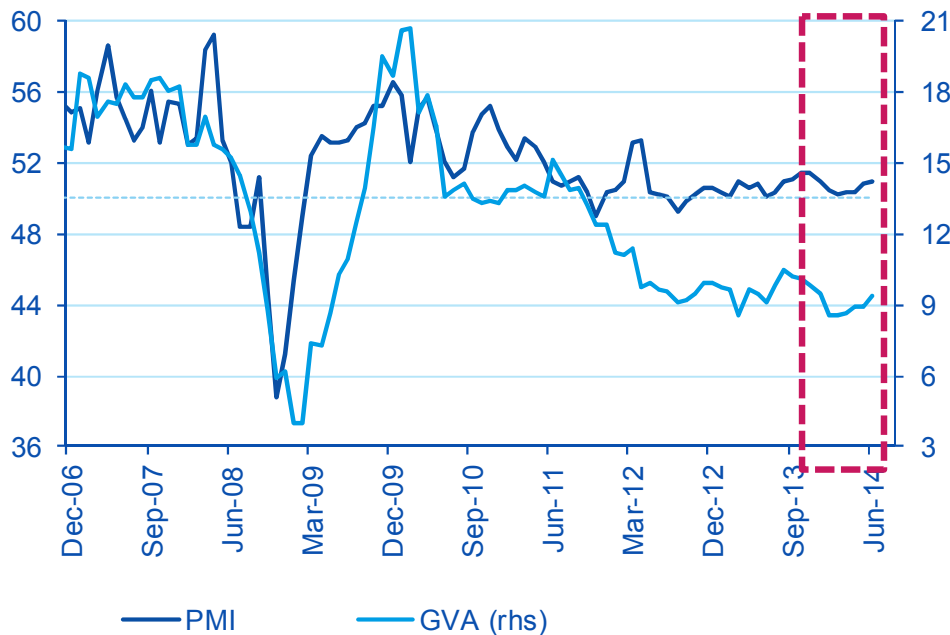
China: lower risk of a sudden adjustment of the economy

Higher foreign demand, fiscal and monetary policy support drive the economic situation in China

The reforms launched to increase competition in the financial sector and to promote private foreign investment should reduce the risk of a sudden adjustment

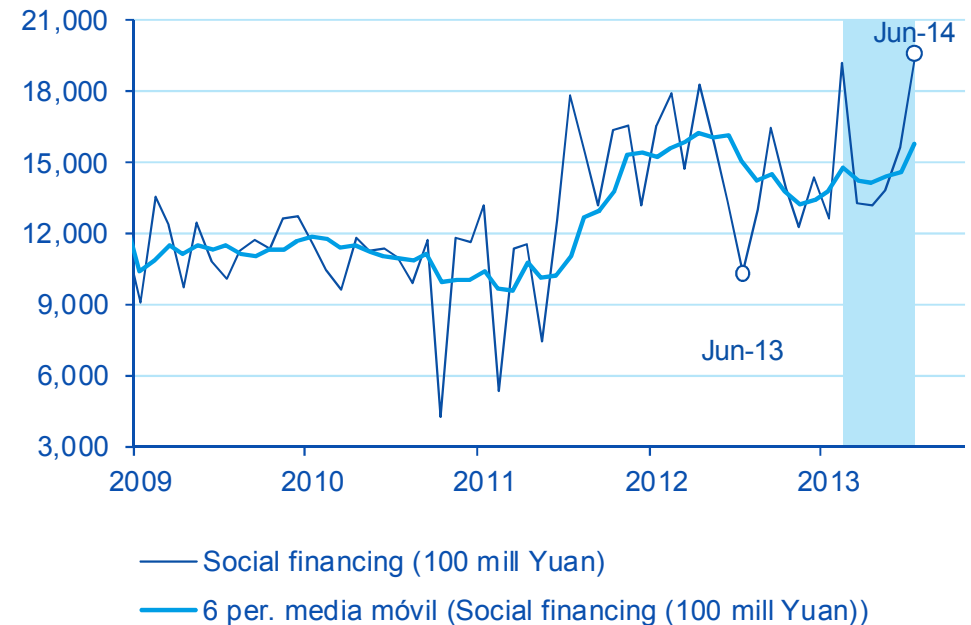
China: confidence and manufacturing production

Source: Haver, BBVA Research



China: total credit flow to the economy 100 million Yuan

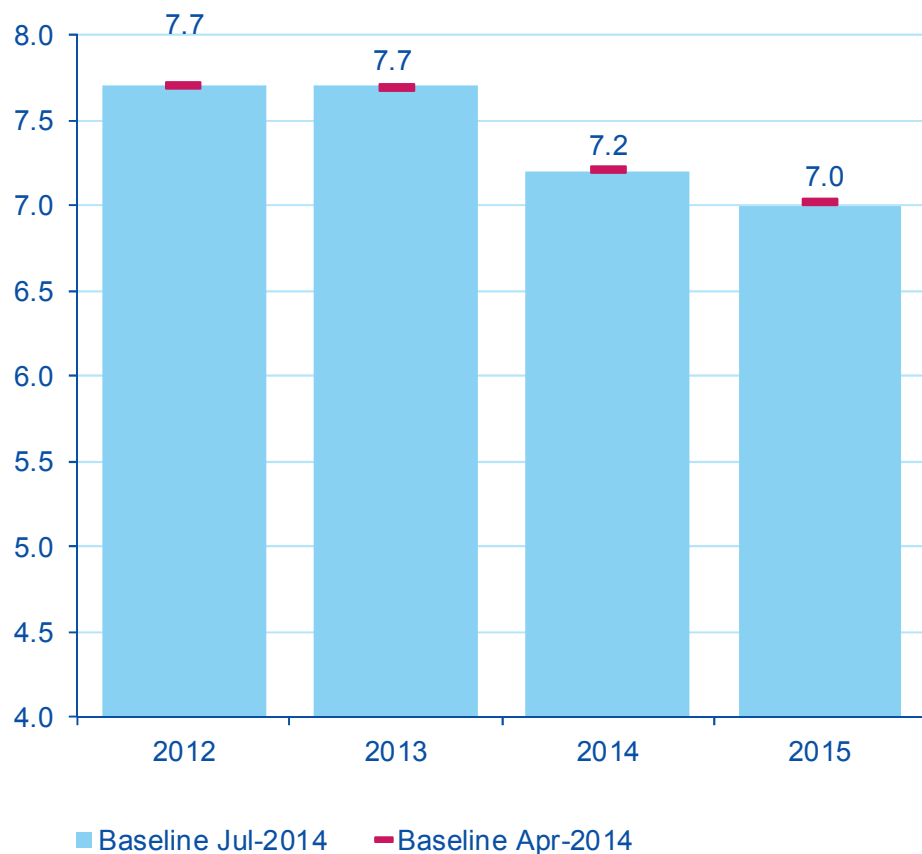
Source: Haver, BBVA Research



China: we keep our baseline scenario

China: GDP growth (YoY %)

Source: BBVA Research



The gradual rebalance from consumption to investment will continue

The Government will continue taking measures to support growth, but is not breaking up with credit dependency

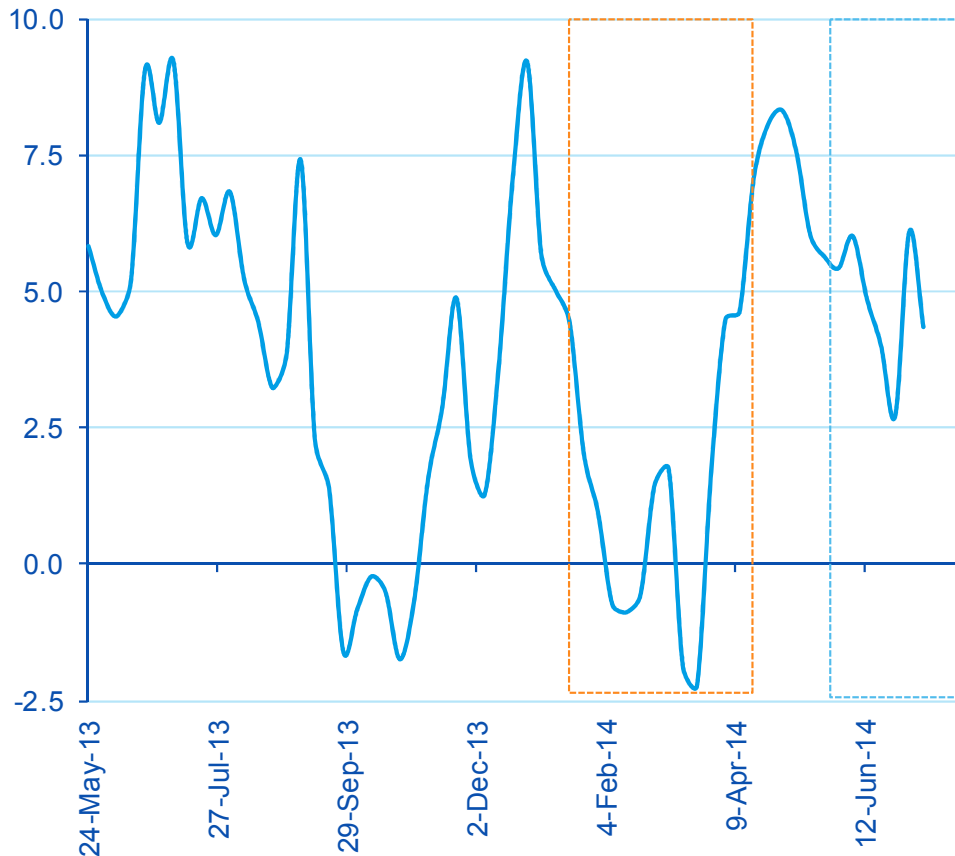
Monetary policy will loosen through lower reserves requirements, while interest rates keep unchanged

US: after a poor Q1, since 14Q2 growth returns

US: BBVA's Weekly Activity Index

QoQ %

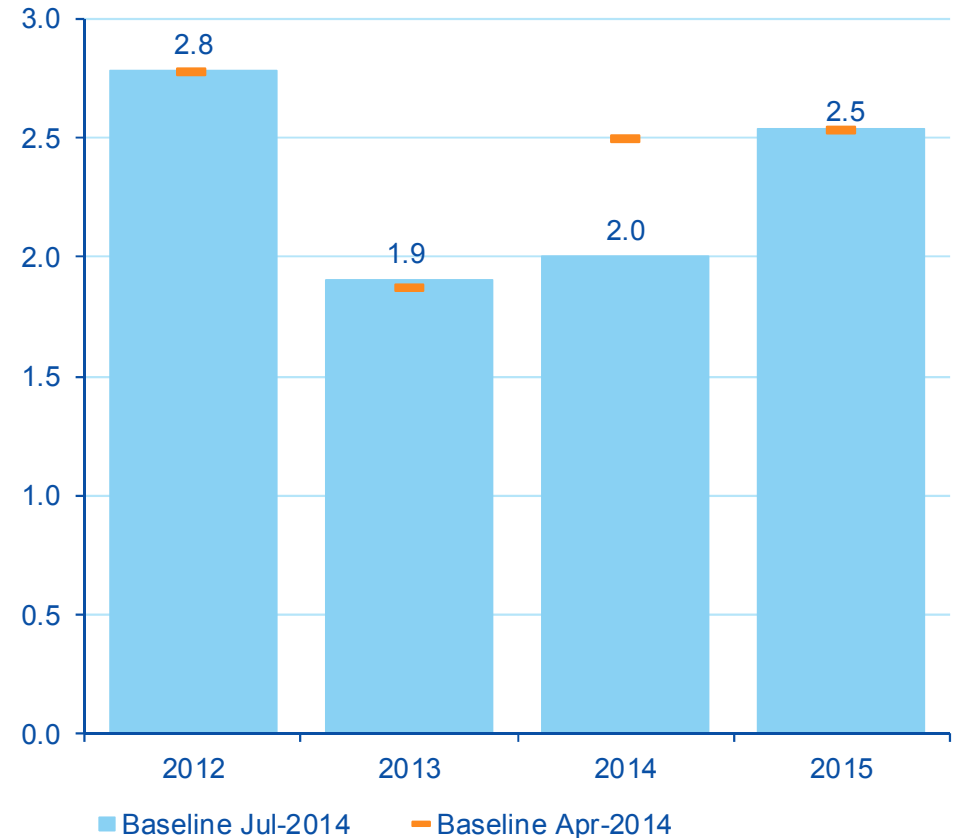
Source: BBVA Research



US: GDP growth

YoY %

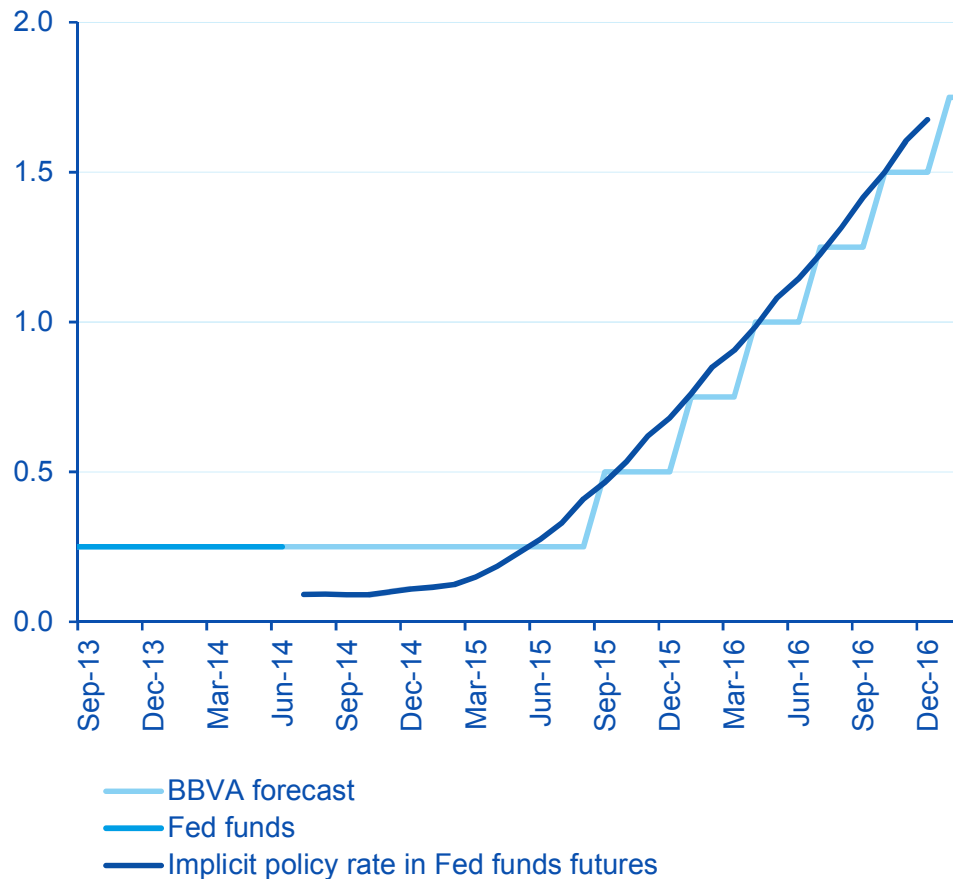
Source: BBVA Research and BEA



US: the Fed will keep pace with recovery, although with the need of higher interest rates

US: Fed funds (%)

Source: BBVA Research and Fed



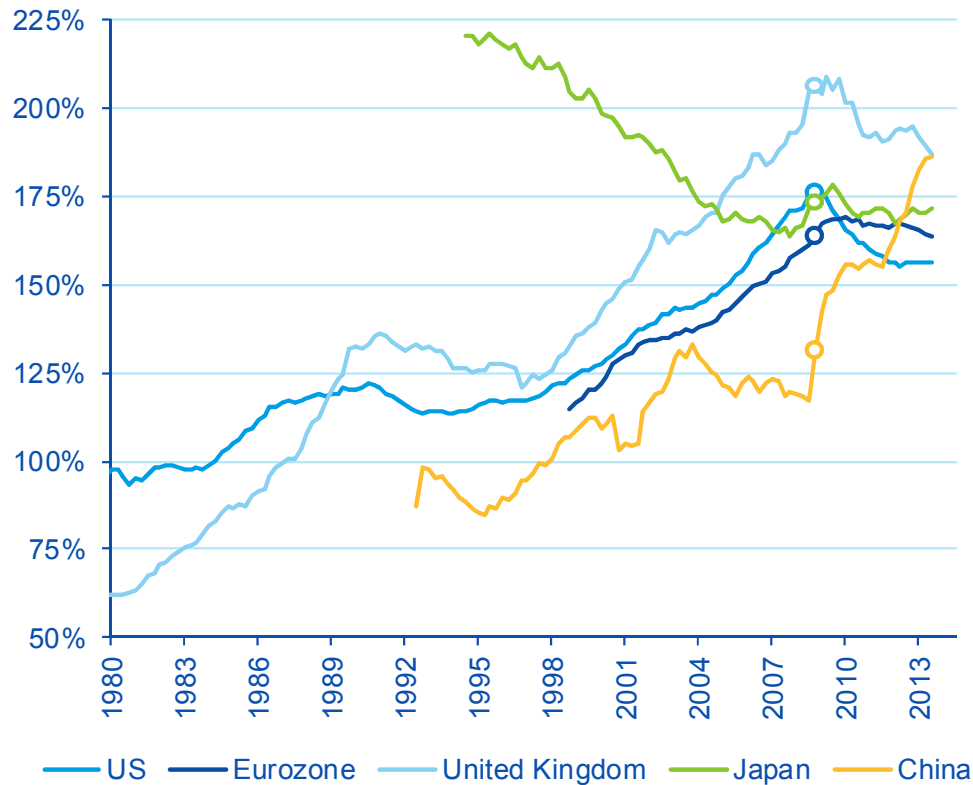
The Fed's balance sheet easing will end in October 2014. Interest rates may rise in September 2015 and their pace will be determined by improvements in the labour market

The Fed's exit communication strategy will become increasingly important

Are we on our way out? Deleveraging in the private sector is slow and total debt continues high

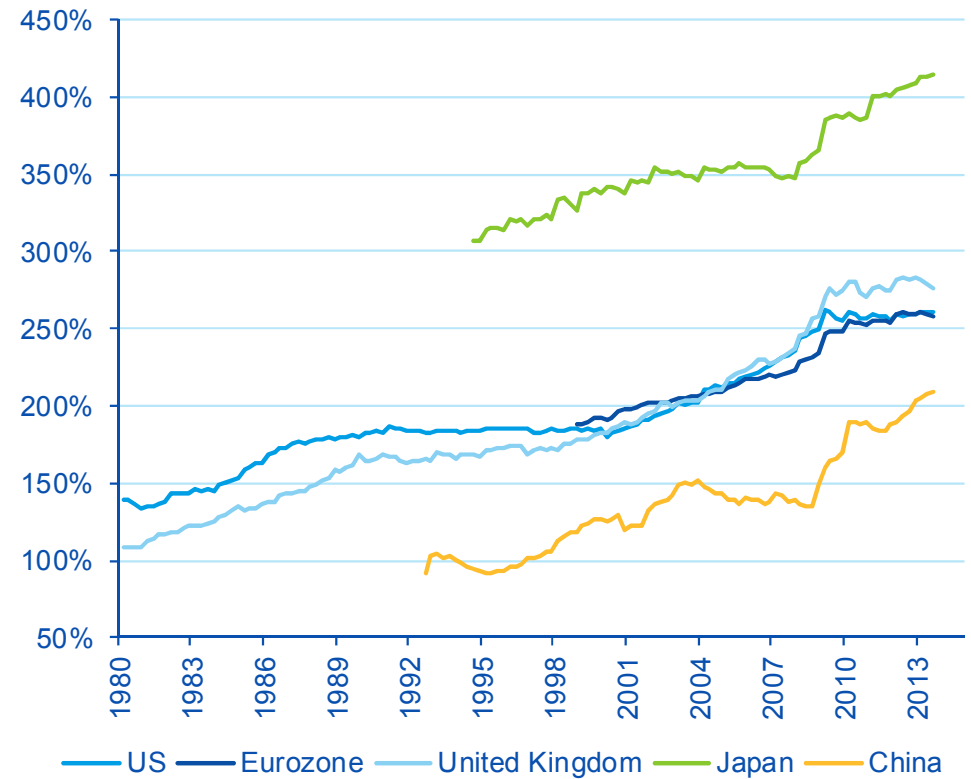
Private non-financial debt (% GDP)

Source: BBVA Research, BIS and OECD



Total private and public debt (% GDP)

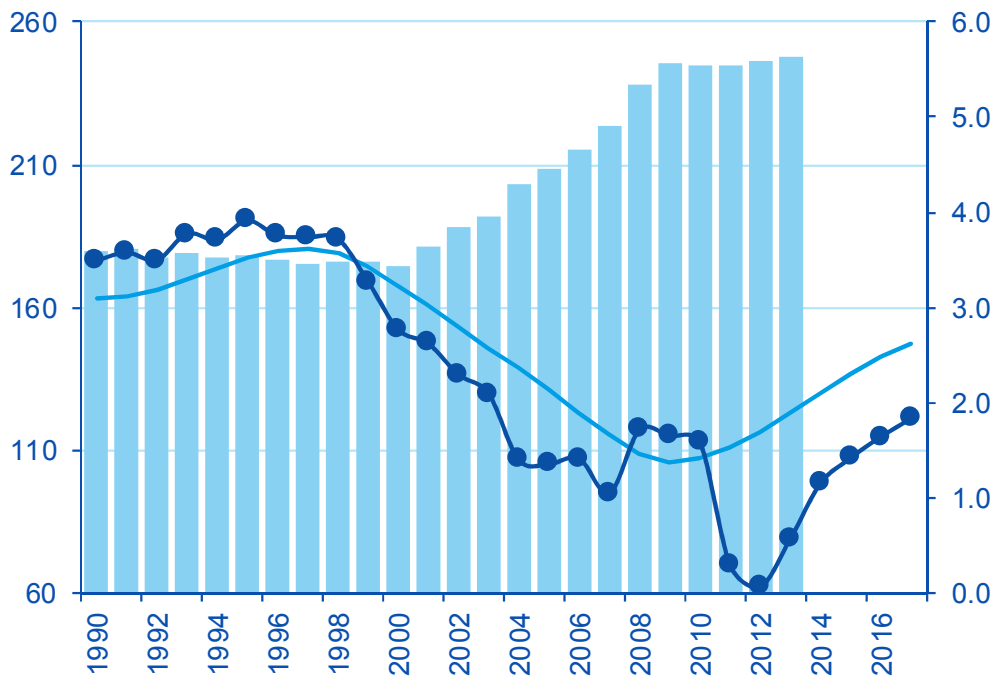
Source: BBVA Research, BIS, OECD, AMECO and IMF



Where is the global economy going?

US: potential growth, real interest rates and total debt

Source: BBVA Research



Agents balance sheet adjustments, which are still pending, could restrain recovery in the mid-term

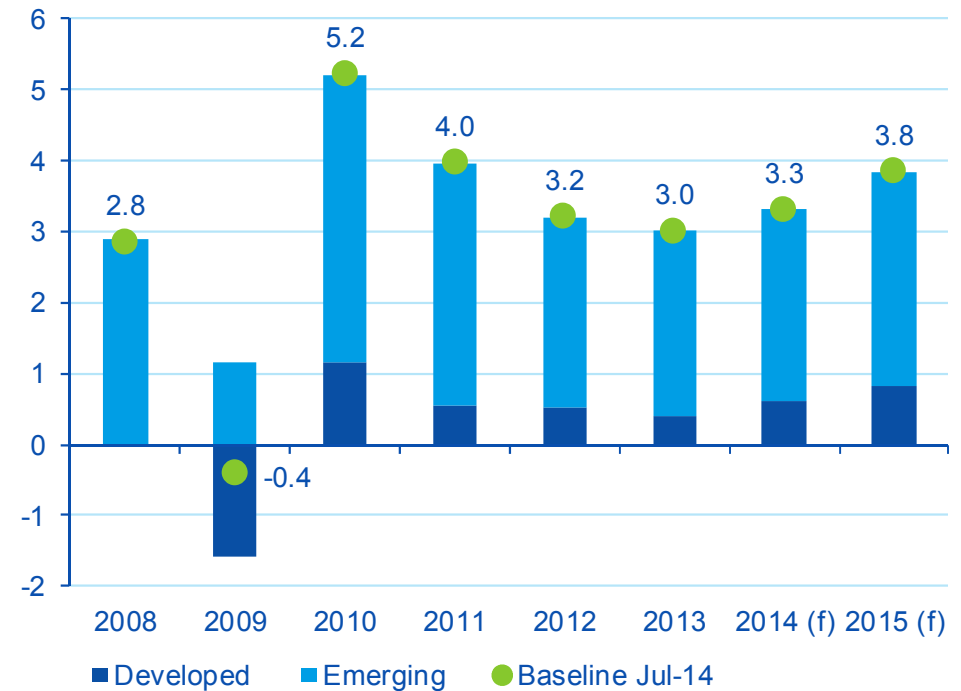
■ US total debt, public and non-financial private sector, % GDP, left axis
— Potential growth, right axis
● 10-year real yield; three-year moving average centered, right axis

Main messages

- 1 **Global growth will continue with improvements in advanced economies**, the US and the Eurozone, while a soft landing is expected in China
- 2 The risk of a severe adjustment in China is low and the Fed holds financial volatility, although **geopolitical risk emerge in many places**
- 3 **Agents balance sheet adjustments, which are still pending**, could restrain recovery on the mid-term

Global GDP growth (%)

Source: BBVA Research



Index

Section 1

The global economy keeps growing

Section 2

The drivers of growth: greater contribution of monetary policy

Section 3

Forecasts: the slow recovery in the eurozone continues

Section 4

Some imbalances have been corrected, but the growth potential is reduced

Annex

Country breakdown

Drivers of the (slow) growth in the eurozone

1) **New data:** first and second quarters worse than expected

2) **Financial environment:** remains positive despite episodes of stress

3) **External environment:** continues to support the activity, but with some doubts

4) **Fiscal policy:** in 2014 and 2015, it'll be less restrictive than in previous years

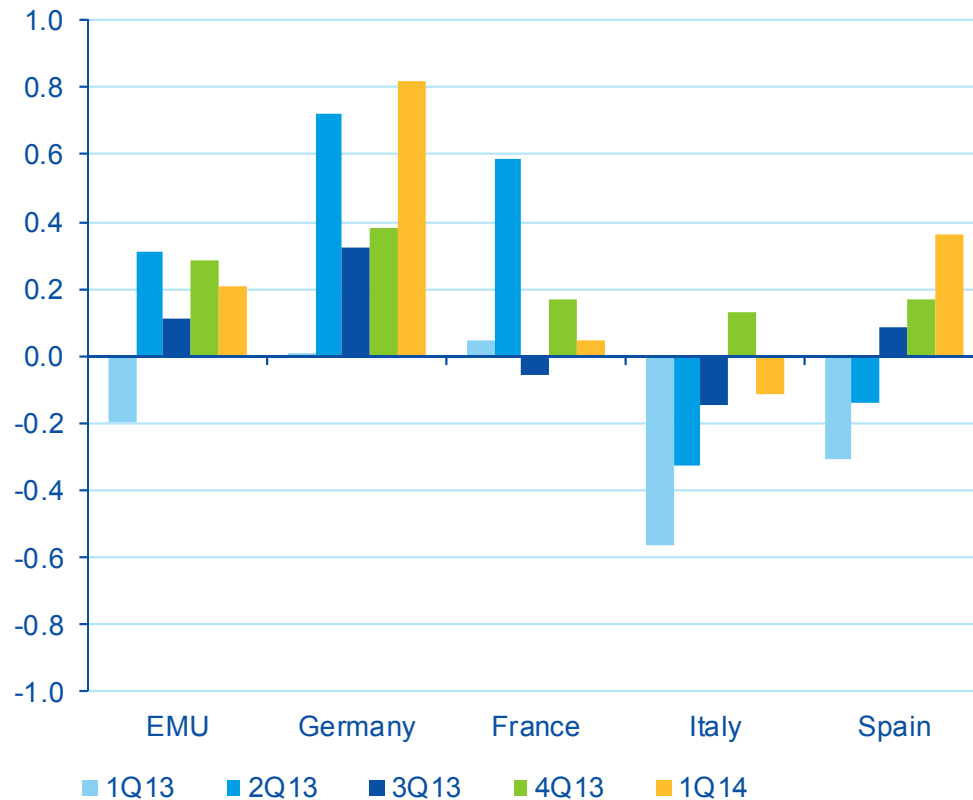
5) **Monetary policy:** the new ECB measures should have a positive impact on credit and interest rate expectations

6) **Banking union:** progresses, broadly as expected, and should help a credit recovery after stress tests

1) Available data: GDP grows somewhat less than expected in 1Q14

GDP growth (% QoQ)

Source: BBVA Research



GDP growth is moderately positive from 2Q13, after a second recession

The first quarter was worse than expected (0.2% vs 0.4%) with negative surprises in France and Italy

Eurozone: quarterly GDP growth (%) by components

	2Q13	3Q13	4Q13	1Q14	
				Observed	BBVA Research
GDP	0.3	0.1	0.3	0.2	0.4
Private consumption	0.2	0.1	0.0	0.1	0.2
Public consumption	0.0	0.2	-0.4	0.3	0.1
Investment	0.2	0.5	0.9	0.3	0.8
Stock chg (1)	-0.2	0.3	-0.2	0.2	0.0
Domestic demand (1)	-0.1	0.6	-0.1	0.4	0.4
Exports	2.4	0.0	1.4	0.3	0.6
Imports	1.6	0.9	0.7	0.8	0.6
Net exports (1)	0.4	-0.4	0.3	-0.2	0.0

(1) Contributions to quarterly GDP growth

Sources: Eurostat and BBVA Research

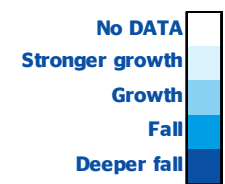
1) Available data: short-term indicators, hesitant lately

			2012	2013	2014
National accounts	GDP	Mar			
	Private consumption	Mar			
	Public consumption	Mar			
	Gross fixed capital formation	Mar			
	Exports	Mar			
	Imports	Mar			
Soft data	ESI	Jul			
	Industrial confidence	Jul			
	Consumer confidence	Jul			
	Volume export order books	Jul			
	Volume of order books	Jul			
	Unemployment expectations	Jun			
	PMI manufacturing	Jul			
	PMI services	Jun			
Hard data	Industrial production	May			
	Domestic new orders	May			
	Foreign new orders	May			
	Passenger car registration	Jun			
	Retail Sales	May			
	Exports of goods	May			
	China	May			
	USA	May			
	Imports of goods	May			

Confidence indices are more positive since the beginning of the year, although moderating in 2Q

Activity indicators still fail to reflect the improvement in confidence

Exports and industrial production have been more hesitant recently

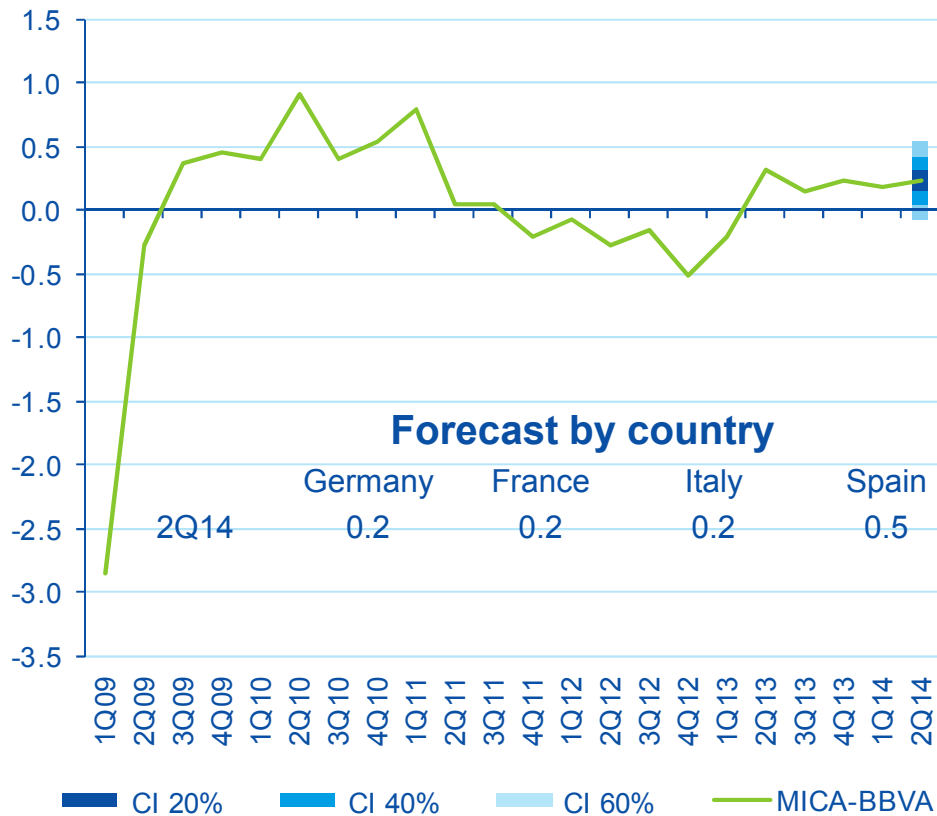


Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken. For confidence data, standardized values are used, and the growth and fall are related to the mean.

1) Available data: in 2Q14 weak growth is expected, with no acceleration

GDP short-term MICA-BBVA model (% QoQ)

Sources: Haver and BBVA Research



The MICA-BBVA forecasts GDP growth of 0.2% QoQ in 2Q14, similar to the first quarter

By country, Germany's growth could slow sharply after temporary factors vanished...

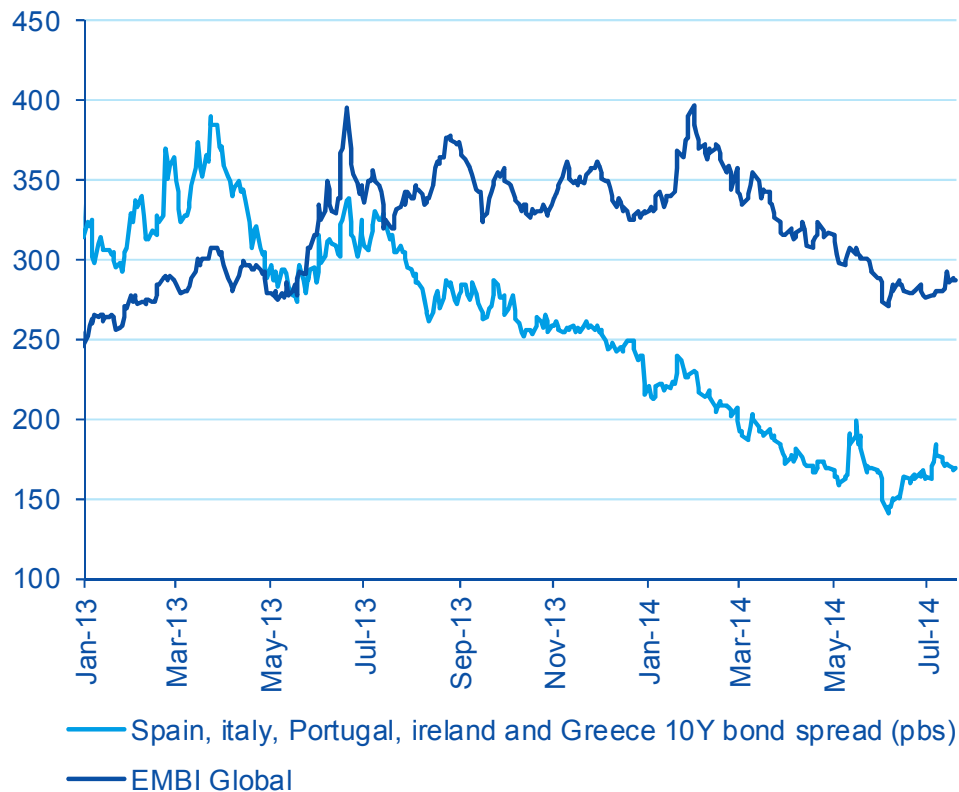
... similar to growth in France and Italy; while Spain continues to accelerate

2) Improvement of the financial environment

- Risk premia have withstood the periphery recent episodes of stress (Portugal, Ukraine)
- However, the German bond rates are lower for the change in monetary policy and the shelter effect

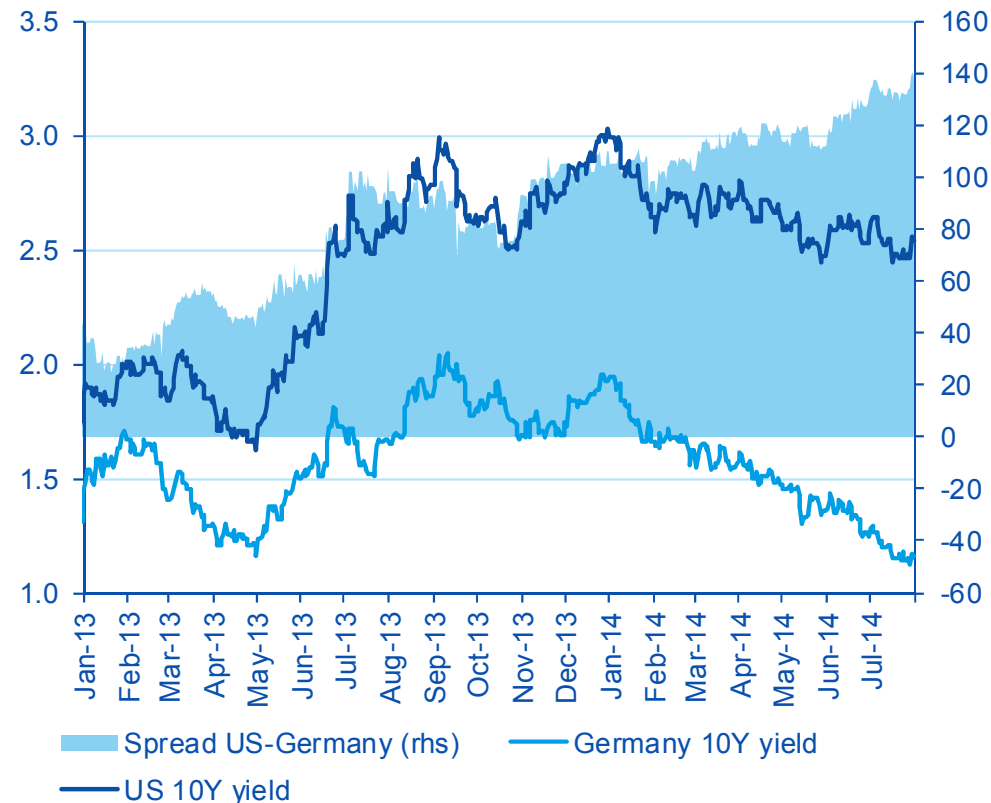
Risk in the European periphery and risk of EM

Sources: Bloomberg and BBVA Research



10-year bonds yield: USA and GER., %

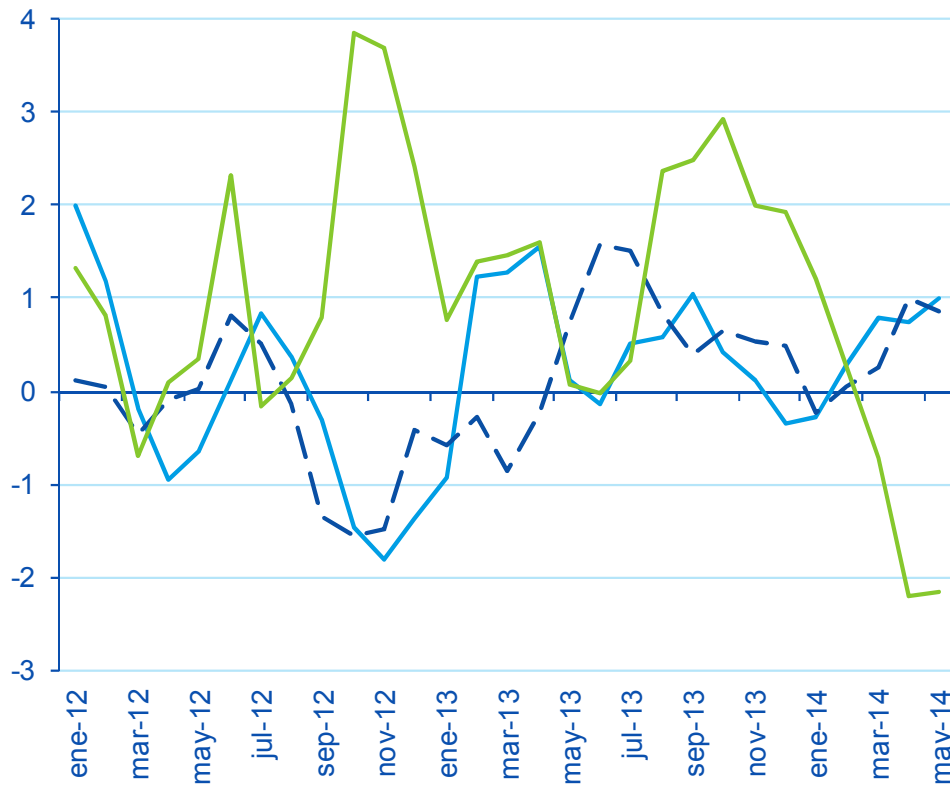
Sources: Bloomberg and BBVA Research



3) Positive external environment, supported by increasing demand from developed countries, but concerns about geopolitical tensions

EMU: exports and foreign demand (% 3m/3m)

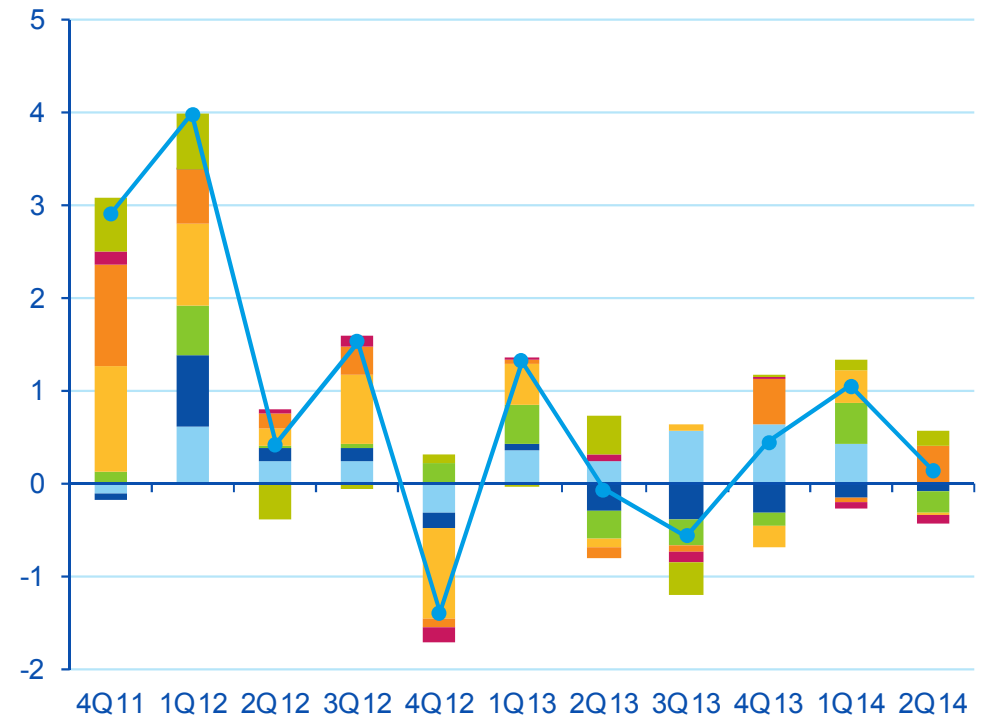
Source: CPB Netherlands and BBVA Research



— Eurozone Exports
— Advanced Imports
— Emerging imports

EMU: exports (% 3m/3m)

Source: Eurostat and BBVA Research

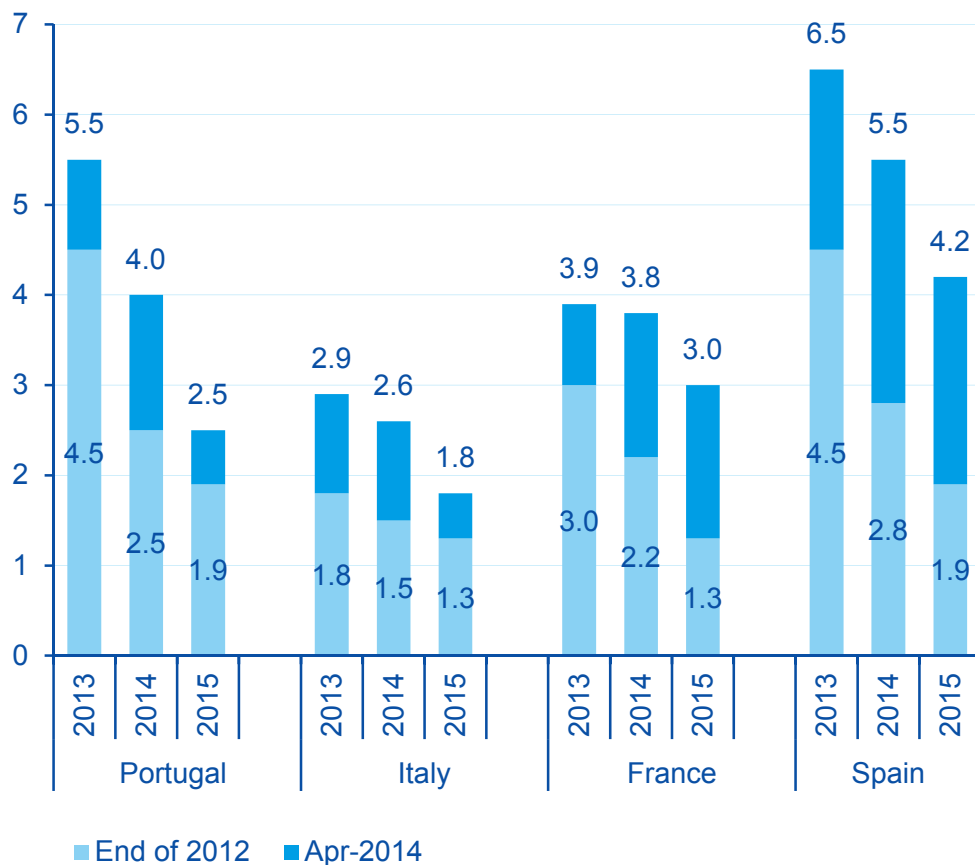


Other European Union
Africa
Asia
Rest
Other European
America
Oceania
Total

4) Fiscal policy is less restrictive than in previous years

Change in public deficit targets (% GDP)

Sources: Eurostat and BBVA Research



The Ecofin relaxed fiscal targets in May 2013 to avoid an excessively procyclical policy

The 3% target was delayed in six countries, including Portugal, Spain, France and Italy

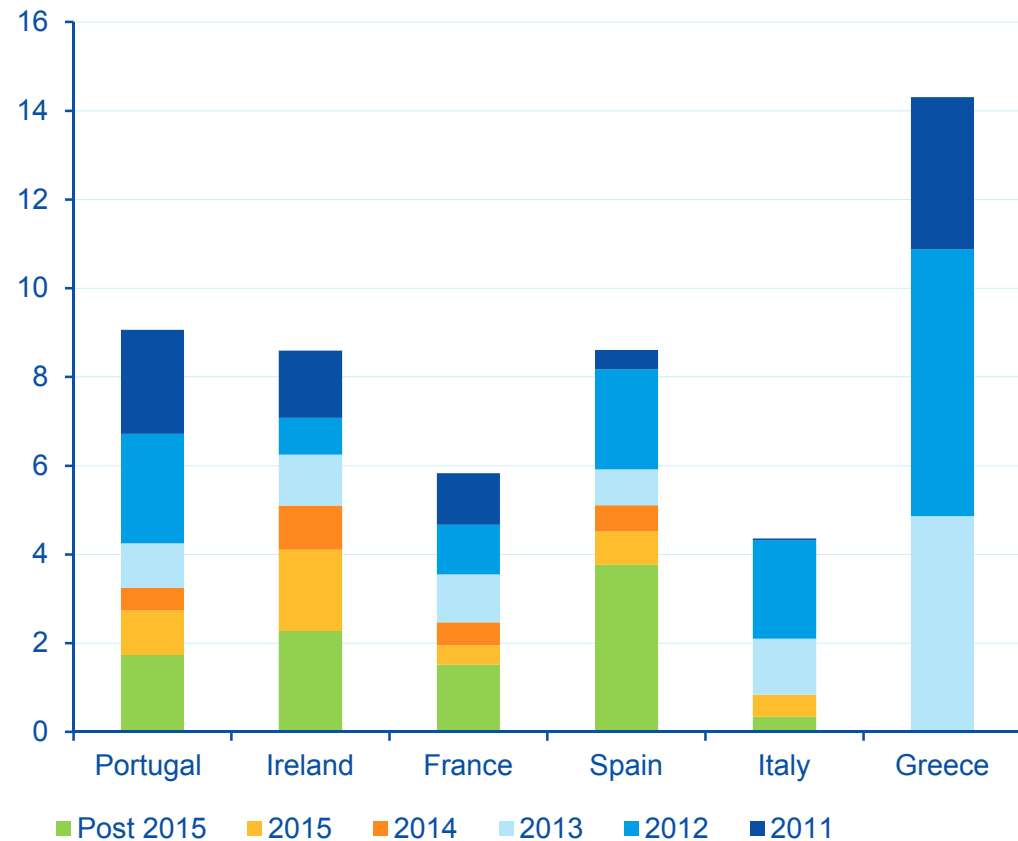
The fiscal stance is now less restrictive

4) Fiscal policy is less restrictive than in previous years

Adjustment of the structural public deficit 2010-2015

(% GDP)

Source: BBVA Research



The adjustment of the structural deficit will be lower in 2014 than in previous years

The structural deficit after 2015 will remain positive and will need further adjustment to meet the fiscal rules

5) The ECB unveils an ambitious set of measures, but falling short of QE

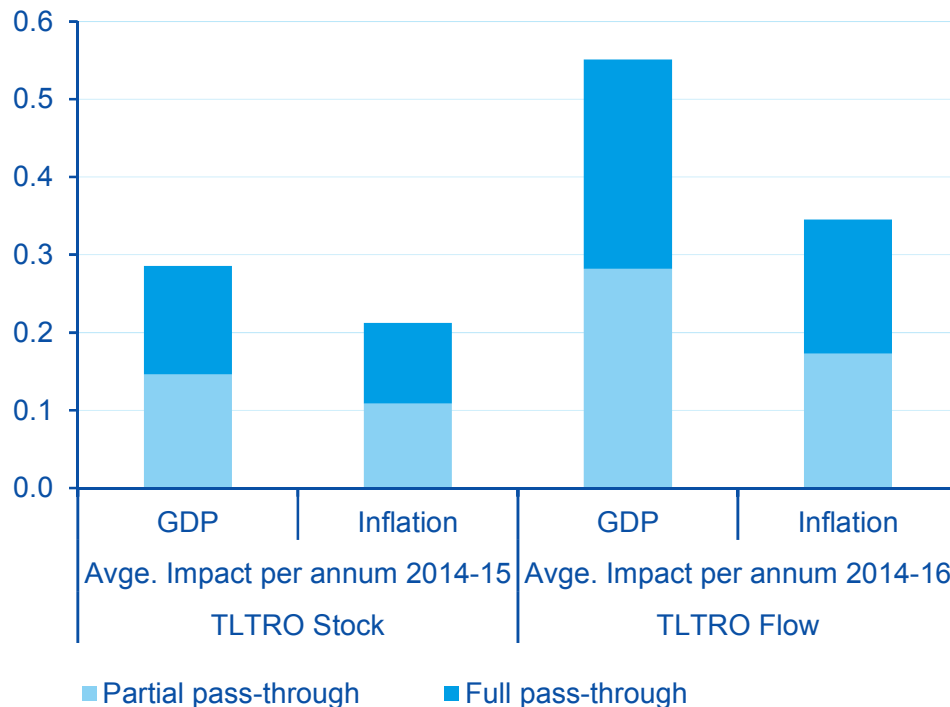
Measure	Goal/ Channel	Potential impact
Reducing key interest rates (including negative deposit rate)	<ul style="list-style-type: none"> • Reinforcement of forward guidance • Enhancing the transmission of monetary policy channel • Easing monetary stance • Assurance of liquidity (cheap and for a long period). 	Lower funding cost and low volatility for a long period of time (Lower Euribor rates for 2015 and 2016)
Prolonging the FRFA (fixed-rate full-allotment tender procedure)		Lower fragmentation in the EZ (lower credit spreads)
SMP program: Suspending sterilization		Asset prices <ul style="list-style-type: none"> • Risk premia in the periphery to remain contained. • EUR-USD depreciation
Targeet LTROs at fixed rates		Credit and growth is expected to be positive in the short term, while the size will depend on the take-up of TLTRO and credit demand

Leaving the door open for outright purchases of private (ABS) and sovereign debt (QE)

5) ECB: How much will the TLTRO impact on growth and inflation? Between 0.1pp and 0.5pp

Euro area: impact of the credit increase due to TLTRO (pp)

Source: BBVA Research



The impact depends on

- Actual take-up of liquidity by banks
- Willingness to transform it into loans

Partial pass-through: Outstanding loans increase by 2% of GDP. Peripheral countries take all funds (€175bn), core countries around 30% (€82bn). Around 2% of loan stock or nominal GDP
Full pass-through: Outstanding loans increase by 4% of GDP

6) Banking union: bank assessment will be the key event in the second half of 2014

AQR and stress tests

Risks evaluation to examine the major risks, including liquidity, leveraging and funding

Asset quality review (AQR) to examine the quality of bank assets, the evaluation of guarantees and provisions

Solvency test to examine the soundness of banks' balance in stress scenarios

The exercise should be strict enough to dispel any doubts about the strength of balance sheets

Special attention should be paid to AQR, as most of the questions are about the current situation of the balances

Index

Section 1

The global economy keeps growing

Section 2

The drivers of growth: greater contribution of monetary policy

Section 3

Forecasts: the slow recovery in the eurozone continues

Section 4

Some imbalances have been corrected, but the growth potential is reduced

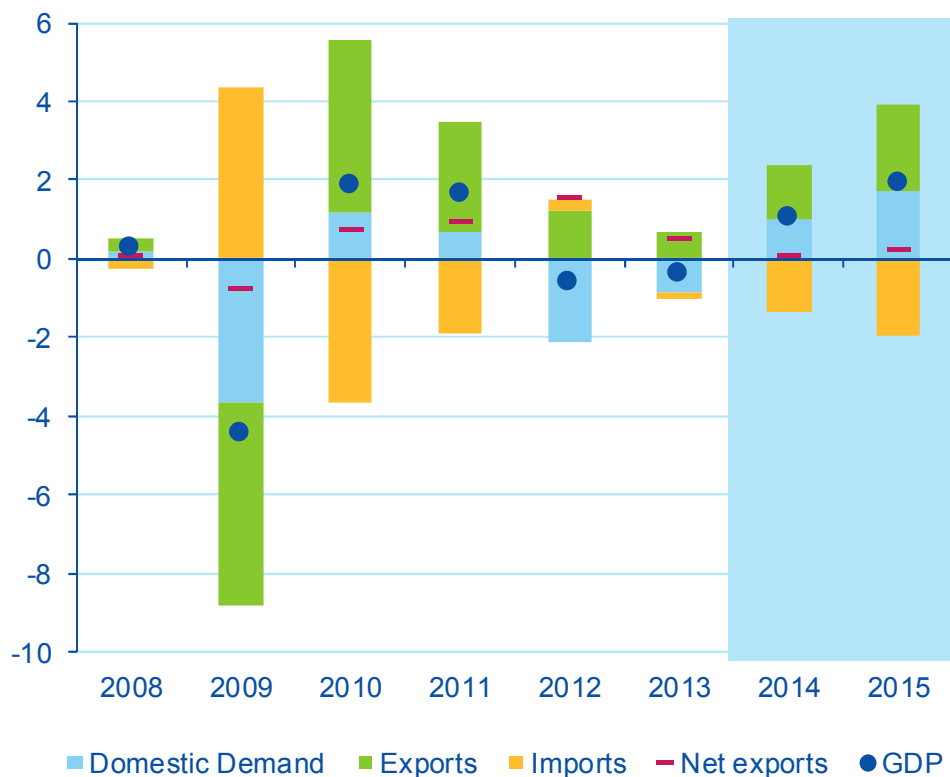
Annex

Country breakdown

Forecasts: gradual recovery in 2014; the domestic demand plays an increasing role

EMU: annual GDP growth contributions (pp)

Sources: Eurostat and BBVA Research

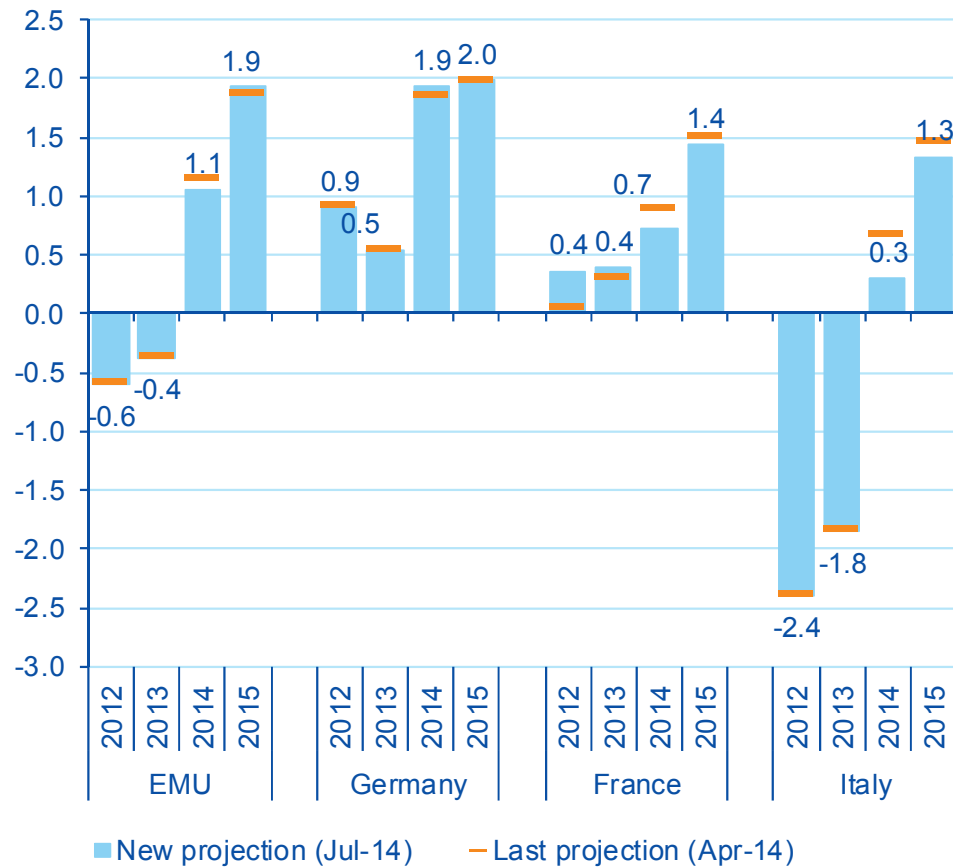


	2012	2013	2014 (f)	2015 (f)
Economic activity				
REAL GDP (% YoY)	-0.6	-0.4	1.1	1.9
Private consumption	-1.4	-0.6	0.7	1.4
Public consumption	-0.6	0.1	0.4	0.7
Investment	-3.8	-2.8	2.5	4.6
Domestic demand (contr. to %)	-2.1	-0.9	1.0	1.7
Exports	2.7	1.5	3.0	4.6
Imports	-0.8	0.4	3.2	4.6
External demand (contr. to %)	1.5	0.6	0.1	0.2
Current account balance (% GDP)	1.2	2.3	2.2	2.1
Public deficit (% GDP)	-3.7	-3.0	-2.6	-2.1
CPI, % avg	2.5	1.4	0.6	1.1

By country: Germany will continue to grow above the rest

GDP forecast by country (%)

Sources: Eurostat and BBVA Research



- Germany continues to lead the recovery thanks to better fundamentals.
- Recent doubts about industrial activity, possibly linked to the crisis in Ukraine

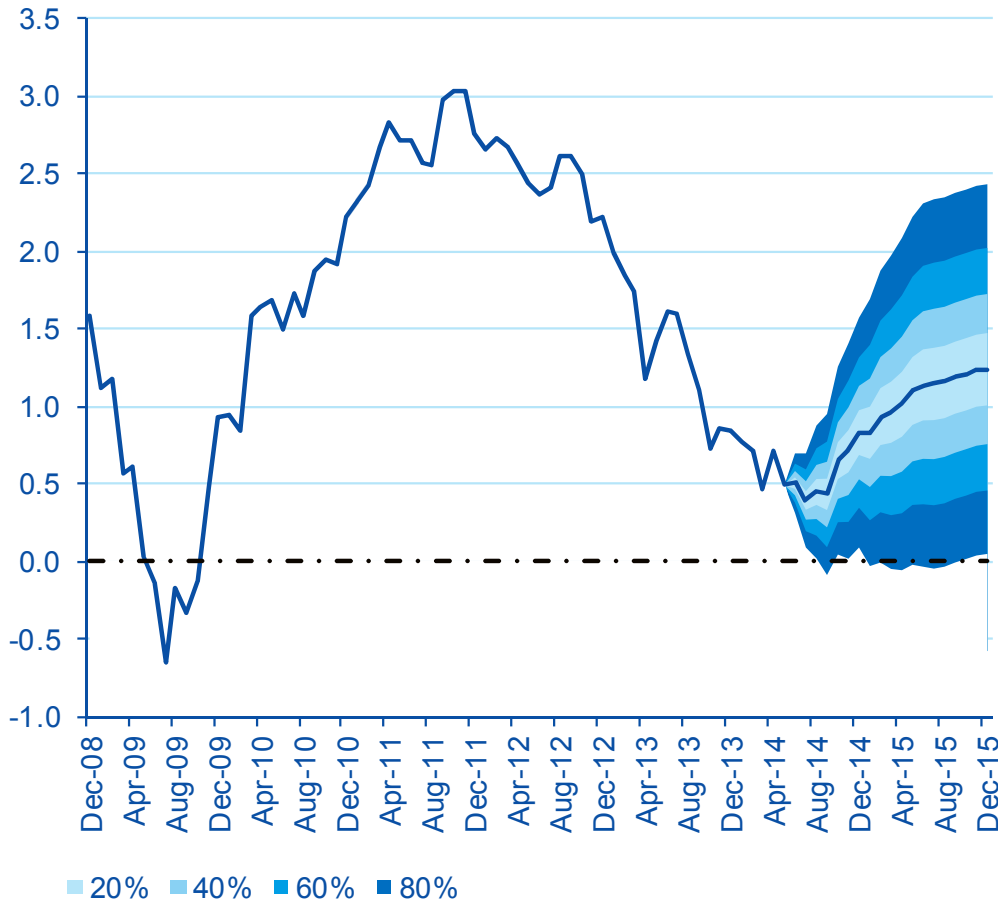
- France doesn't gain momentum yet.
- Recently, positive measures have been adopted to regain competitiveness and reduce public spending

- Italy: weak growth after the downside surprise in Q1
- Extensive reform plans, that need to be materialized

Inflation is expected to remain at very low rates. Deflation risks are limited

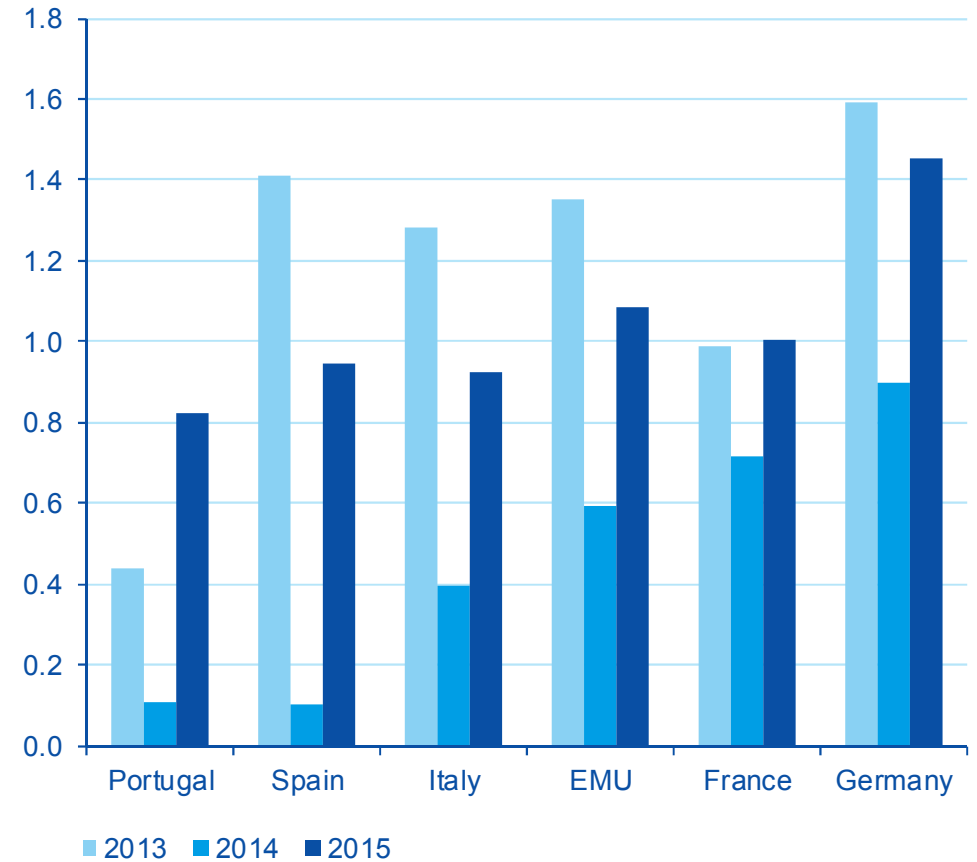
Eurozone: inflation (% YoY)

Sources: Eurostat and BBVA Research



Inflation by country (% YoY)

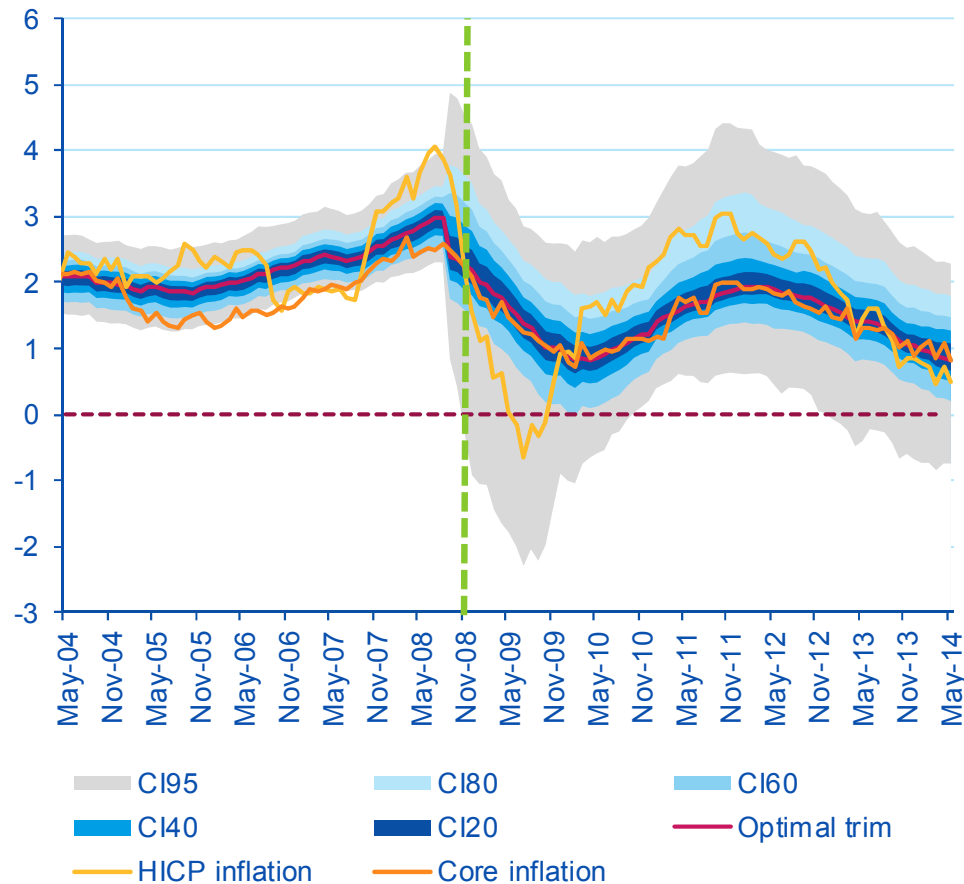
Sources: Eurostat and BBVA Research



Inflation expectations below the ECB's target, but the new measures should help

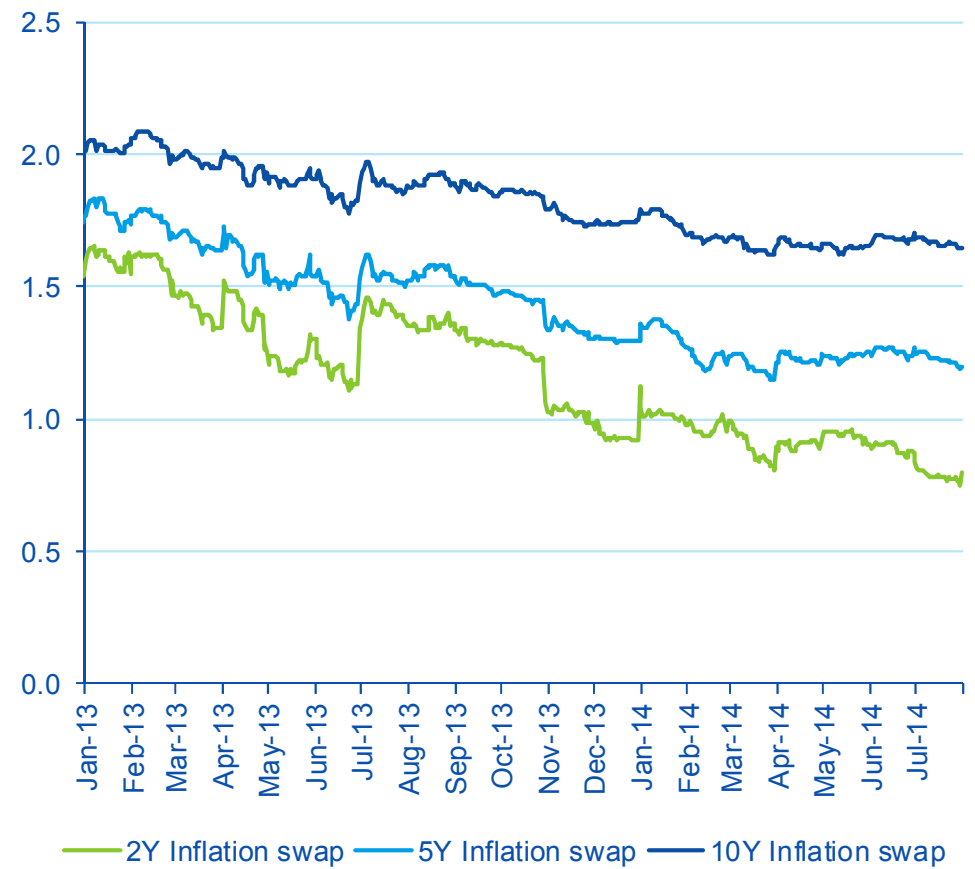
Eurozone: inflation (% YoY)

Source: BBVA Research



Eurozone: inflation swaps expectations (%)

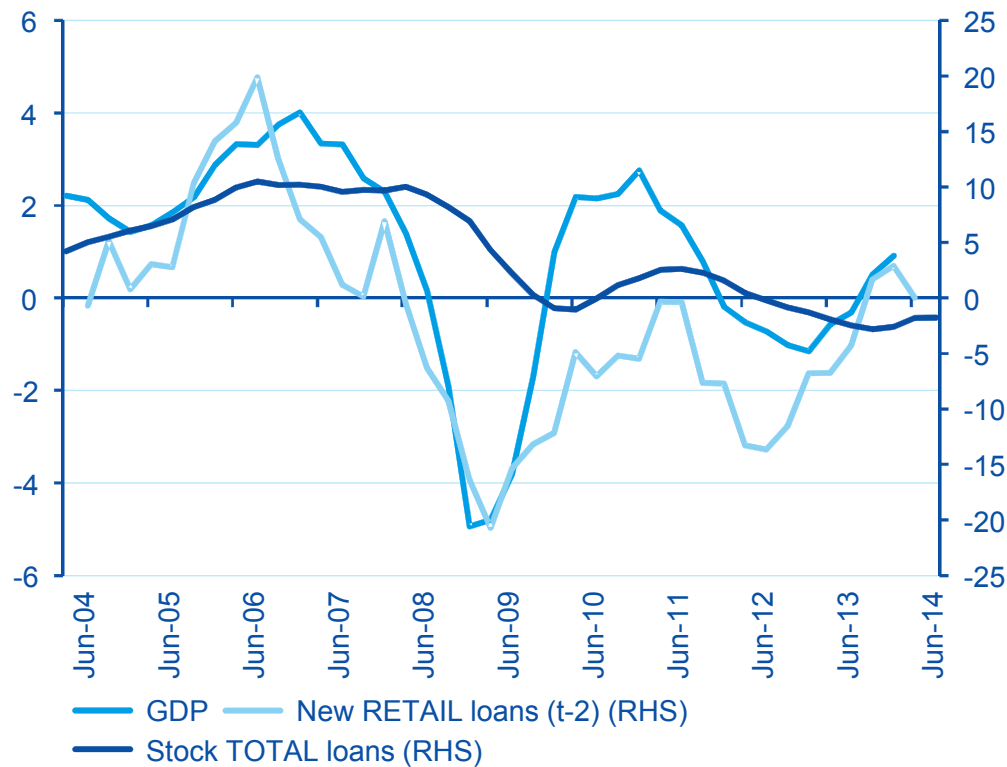
Source: Bloomberg and BBVA Research



The new credit to households and small businesses is growing

Eurozone (% YoY)

Note: Retail loans is the sum of loans to households and to firms up to €1M
 Source: ECB, Eurostat and BBVA Research



The new credit and real variables (consumption and investment) are flows and are strongly correlated (corr of 0.9, compared to 0.6 with the stock of credit)

The new credit to consumers and small and medium enterprises is growing for half a year

The new credit to large companies is still falling, partly because of their growing use of the market

Risks

External

1. Lower growth abroad (US, China)
2. Impact from a problematic Fed exit
3. Geopolitical risks (Ukraine, Iraq, Syria, etc.)

Domestic

1. Persistence of sovereign risk and financial fragmentation
2. AQR surprises
3. Risk of deflation and the burden of a recovery with very low inflation
4. Lack of effectiveness of ECB's measures and market reversion

Index

Section 1

The global economy keeps growing

Section 2

The drivers of growth: greater contribution of monetary policy

Section 3

Forecasts: the slow recovery in the eurozone continues

Section 4

Some imbalances have been corrected, but the growth potential is reduced

Annex

Country breakdown

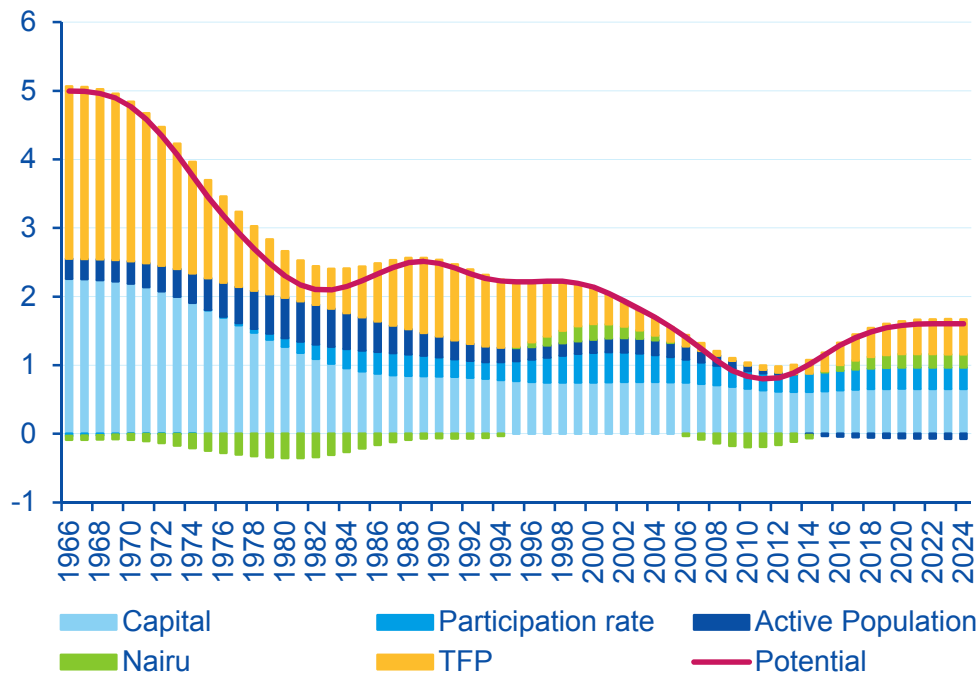
Low potential growth

The crisis has reduced the potential below 1%, but should recover to 1.5%

Lower potential than in US

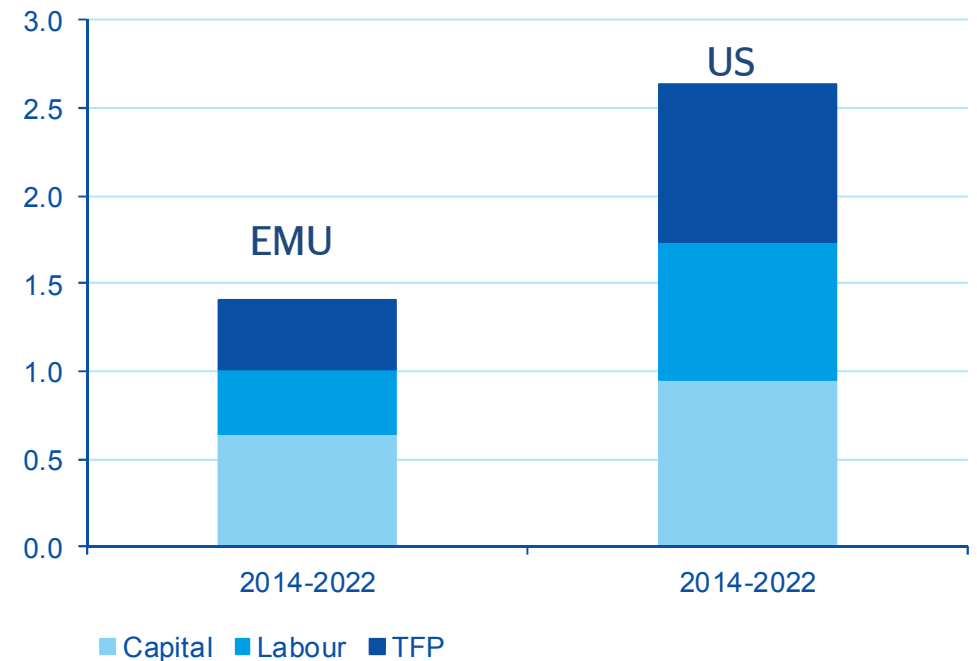
Eurozone: potential GDP growth (%) and factors' contribution (pp)

Source: Eurostat and BBVA Research



US and EZ projected potential GDP growth (pp)

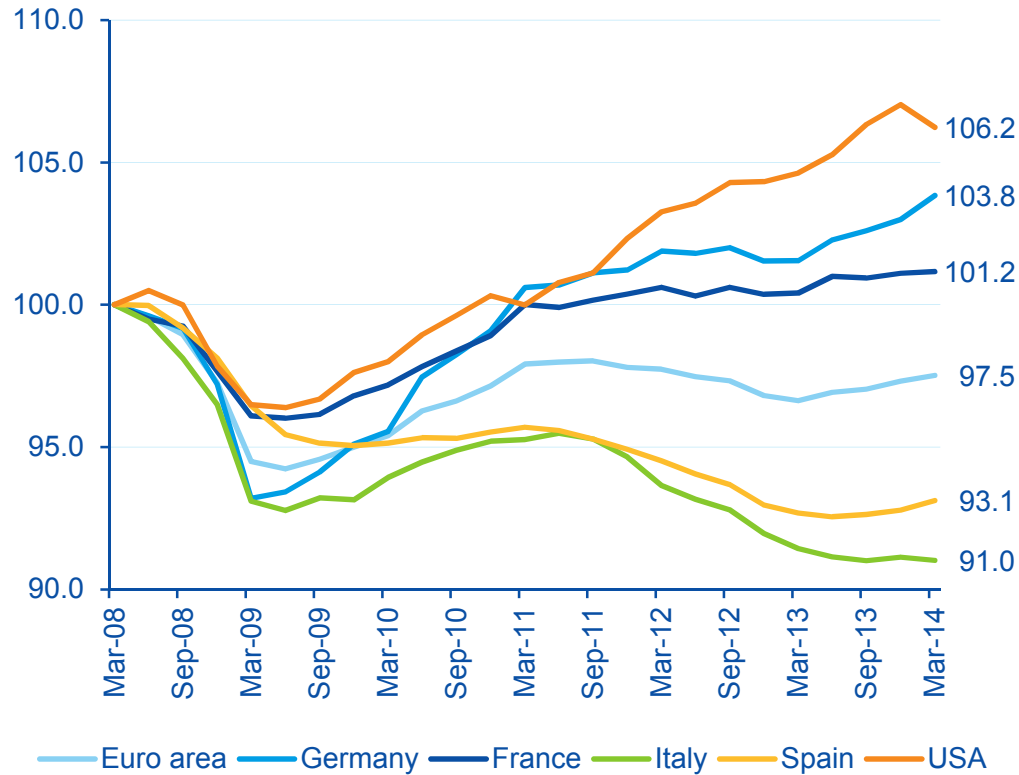
Source: Eurostat and BBVA Research



The impact of the crisis: US vs core vs periphery

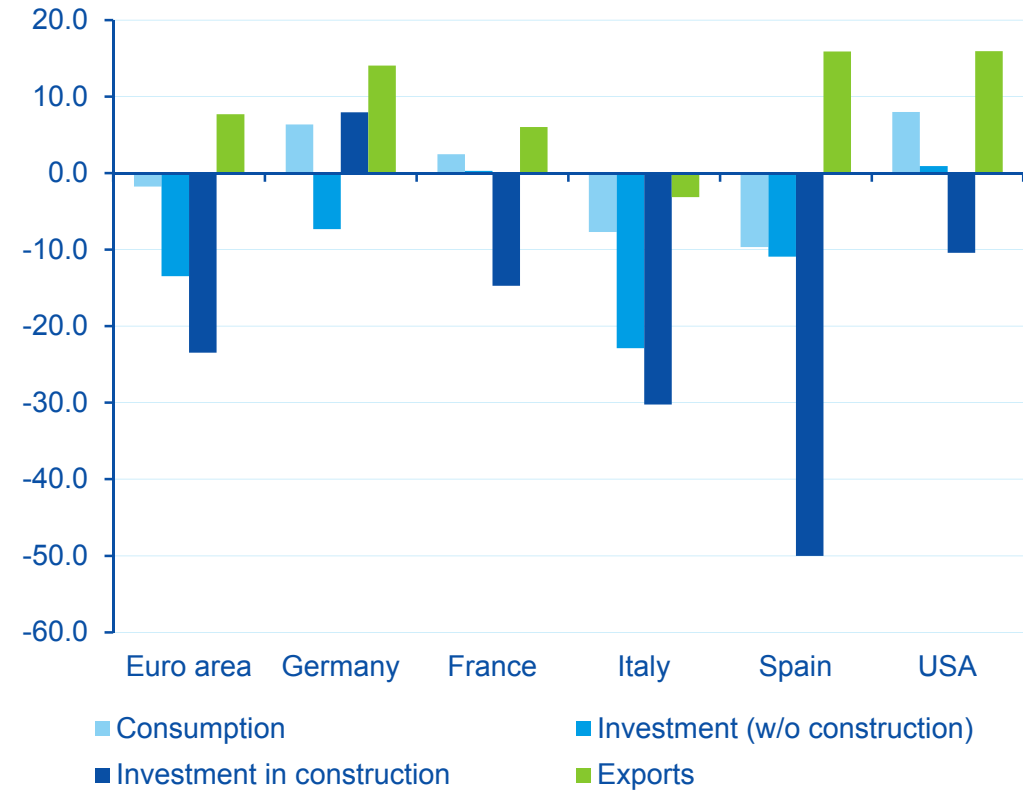
GDP

Note: Q1-2008=100
Source: Eurostat, Haver and BBVA Research



Components

Note: Q1-2008=100
Source: Eurostat, Haver and BBVA Research



Heat map of macroeconomic imbalances

	Public Debt % of GDP Q4-2013	Public Deficit* % of GDP 2013	Unemployment Rate Latest	Current Account % of GDP 2013	Net International Investment Position % of GDP Q4-2013**	Real Effective Exchange Rate 3-yr % chg. Sep. 2013	Nominal Unit Labour Cost 3-yr % chg. Latest	Household Debt % of GDP Latest	Non-Financial Corporations Debt % of GDP Latest
Eurozone	92.7	-2.8	11.8	2.4	-12.2	1.0	3.9	63.9	81.5
GER	78.4	0.0	5.1	7.5	48.3	0.1	6.1	58.2	48.5
FRA	93.5	-4.3	10.4	-1.4	-21.2	-0.7	5.2	56.7	84.0
AUT	74.5	-0.9	4.9	2.7	3.4	2.2	7.3	54.5	92.9
BEL	101.5	-2.8	8.5	-1.6	44.0	0.5	8.6	56.5	92.4
NED	73.5	-2.5	7.2	10.4	53.0	1.5	6.4	127.9	91.5
FIN	57.0	-2.1	8.5	-1.1	15.8	1.9	8.5	65.4	92.5
ITA	132.6	-3.1	12.7	1.0	-30.0	2.0	4.3	45.3	81.0
SPA	93.9	-6.6	25.3	0.8	-98.2	0.8	-5.3	81.3	114.0
POR	129.0	-4.5	15.2	0.5	-118.7	0.2	-1.3	86.8	130.8
IRE	123.7	-6.7	11.8	6.6	-104.9	-2.4	-3.4	105.1	201.3
GRC	175.1	-2.1	26.5	0.7	-119.0	-3.9	-11.1	64.5	64.8
DEN	44.5	-0.9	6.5	7.3	39.6	-1.4	3.8	139.2	97.9
SWE	40.6	-1.1	8.1	6.2	-4.8	3.1	6.2	83.4	121.2
U.K.	90.6	-5.7	6.7	-4.4	-1.3	3.9	6.2	93.1	83.8

Colour criterion:

Higher than 130	Lower than -6	Higher than 16	Lower than -6	Lower than -100	Greater than 6	Greater than 9	Greater than 110	Greater than 140
110/130	-6/-5	13/16	-6/-4	-100/-50	4/6	6/9	90/110	120/140
90/110	-5/-4	10/13	-4/-2	-50/0	2/4	3/6	75/90	100/120
60/90	-4/-3	7/10	-2/0	0/20	0/2	0/3	60/75	80/100
Lower than 60	Higher than -3	Lower than 7	Greater than 0	Greater than 20	Lower than 0	Lower than 0	Lower than 60	Lower than 80

*Excluding aid to the financial sector

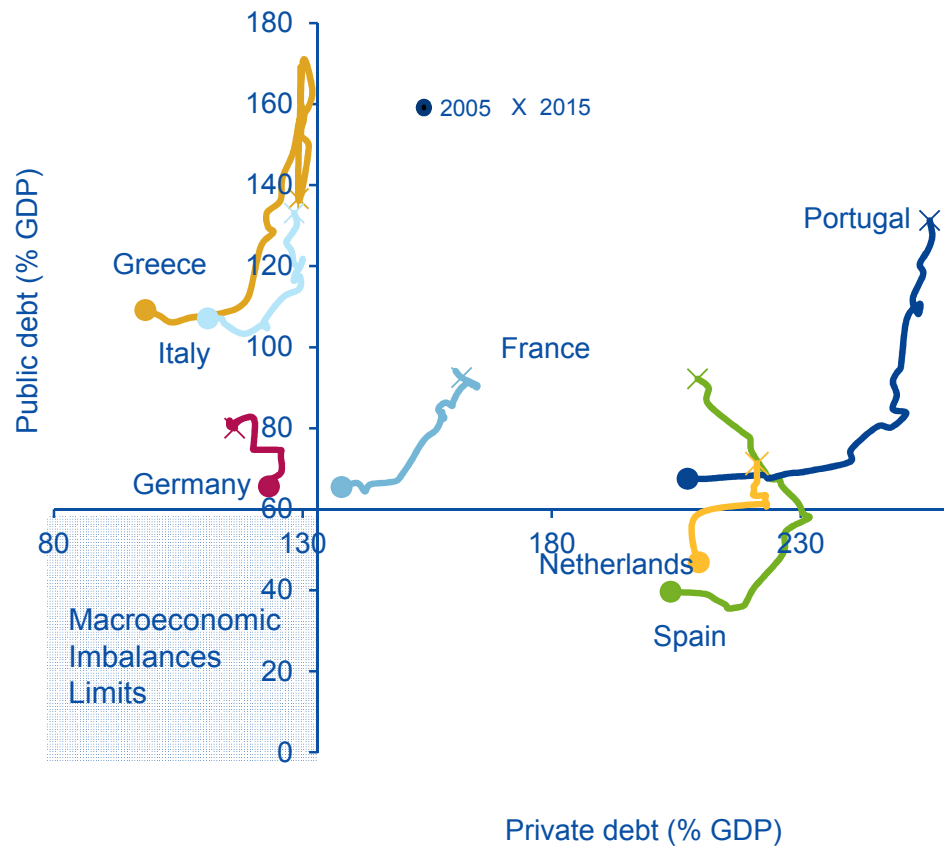
**Data for France: 4Q-2012

Source: Eurostat, BCE, Haver and BBVA Research

Deleveraging isn't in process yet, with exceptions

Public and private debt 2005-2015 (% GDP)

Sources: Eurostat and BBVA Research



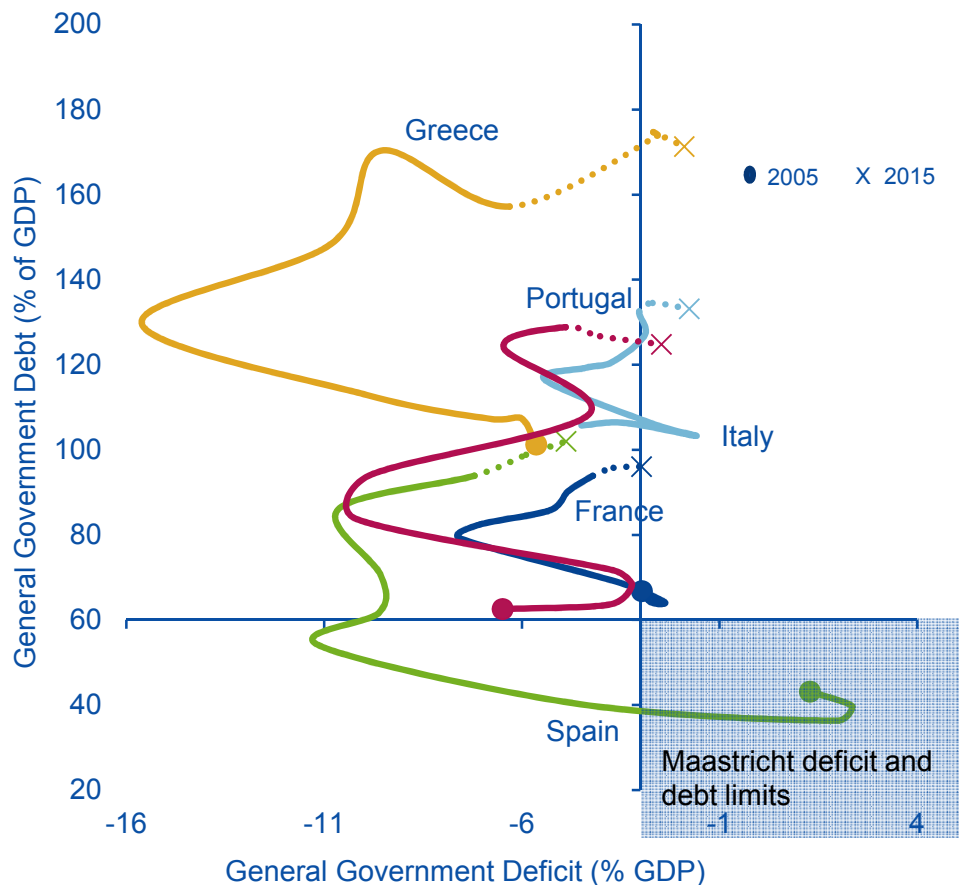
Private debt has stabilized and begun to fall in Spain

The peripheral countries have experienced much larger increases in debt than the core during the crisis

Peripheral countries have reduced public deficits but public debts continue to grow

Government debt and deficit 2005–2015

Source: IMF



The adjustment of the deficit has been huge, especially in the countries subject to the program

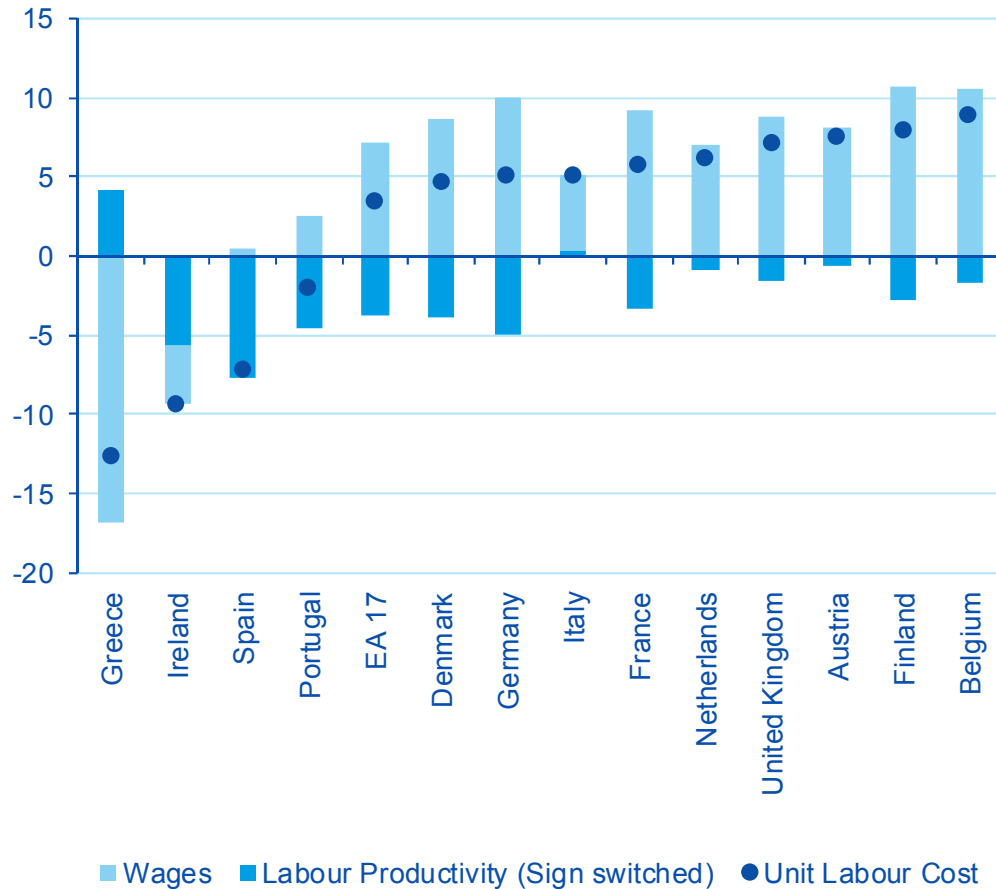
But debt levels have not begun to fall yet

The return to growth and higher inflation are key to rapid deleveraging

Unit labor costs have been adjusted rapidly in the periphery

Unit labour costs adjustment, 2009-2013 (%)

Sources: Haver and BBVA Research



In some countries this was due to increased productivity caused by the decline in employment

Wage moderation has also played an important role, especially in comparison with the core countries

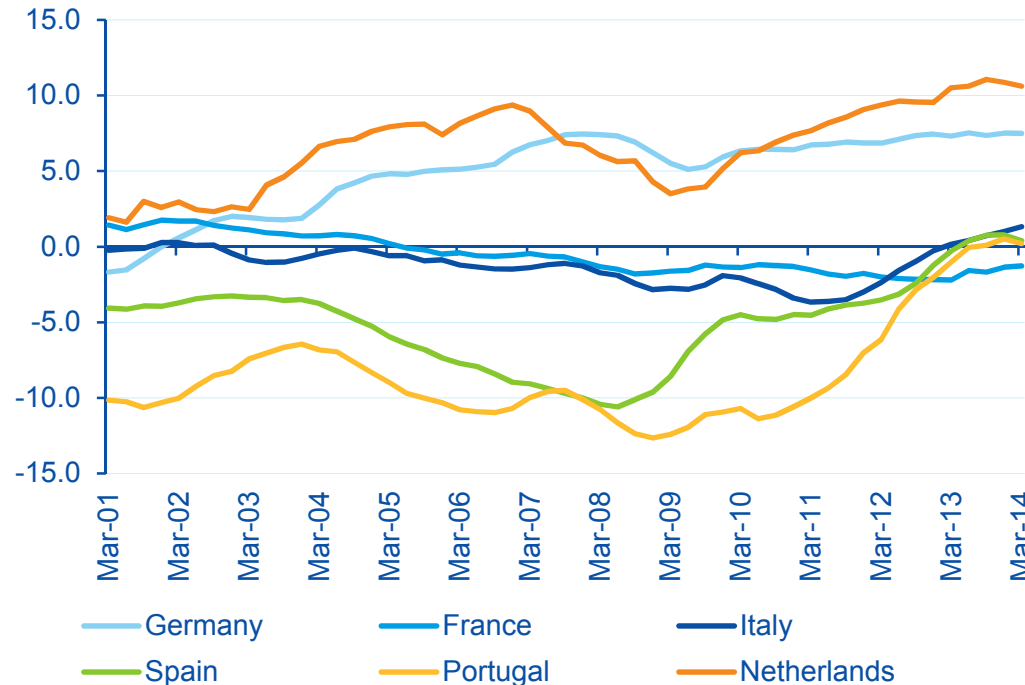
The current account deficits have disappeared very fast

Most countries in the euro zone are now in surplus (except for France)

Part of the adjustment is due to the recession (less imports), but exports have also played an important role

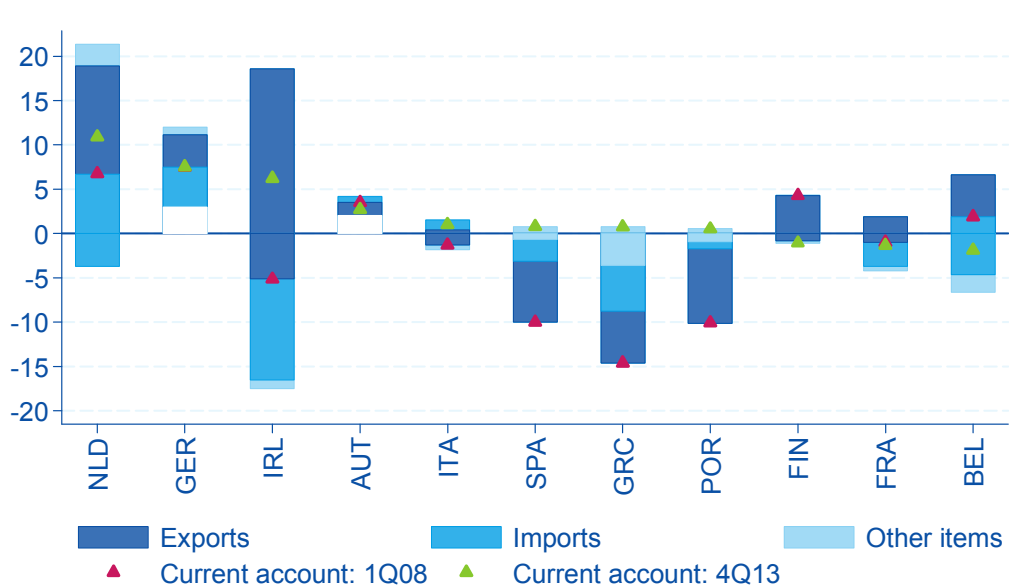
Current account (% of GDP)

Sources: Eurostat and BBVA Research



Current account (% of GDP)

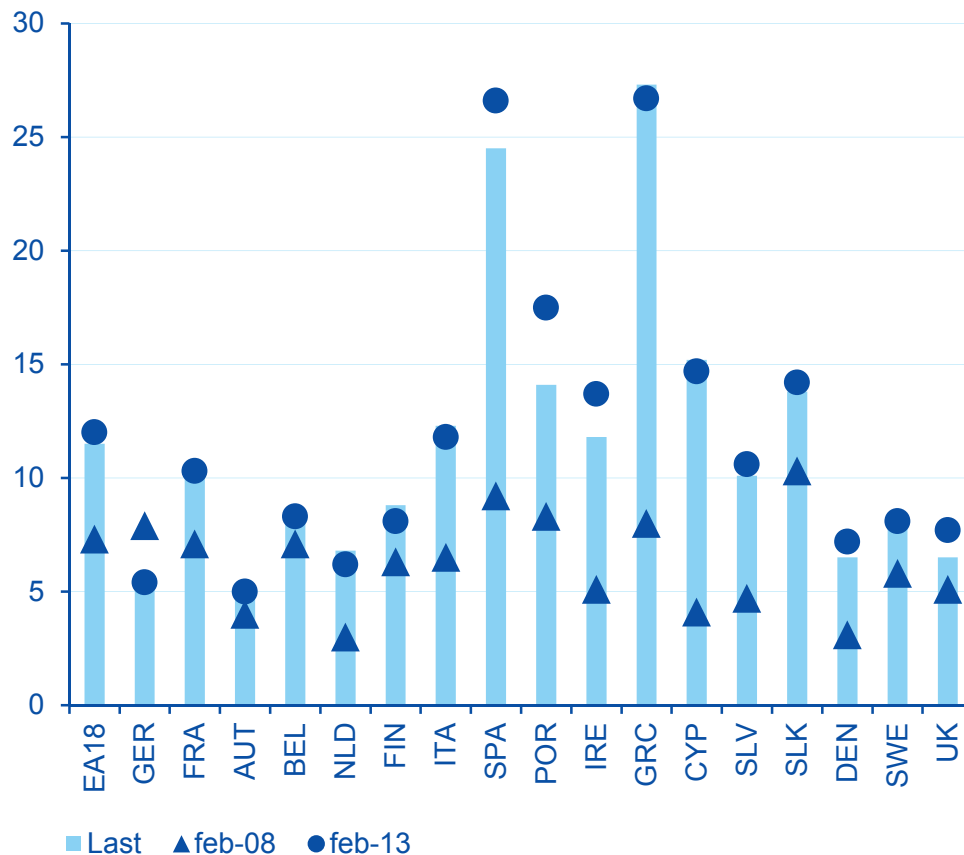
Sources: Eurostat and BBVA Research



The high unemployment remains the main problem of economic policy

Unemployment since the beginning of the crisis (%)

Sources: Haver and BBVA Research



The unemployment rate is well above that of 2008 (except in Germany, Belgium and Finland)

Even so, it has begun to decrease earlier than in other recessions

Index

Section 1

The global economy keeps growing

Section 2

The drivers of growth: greater contribution of monetary policy

Section 3

Forecasts: the slow recovery in the eurozone continues

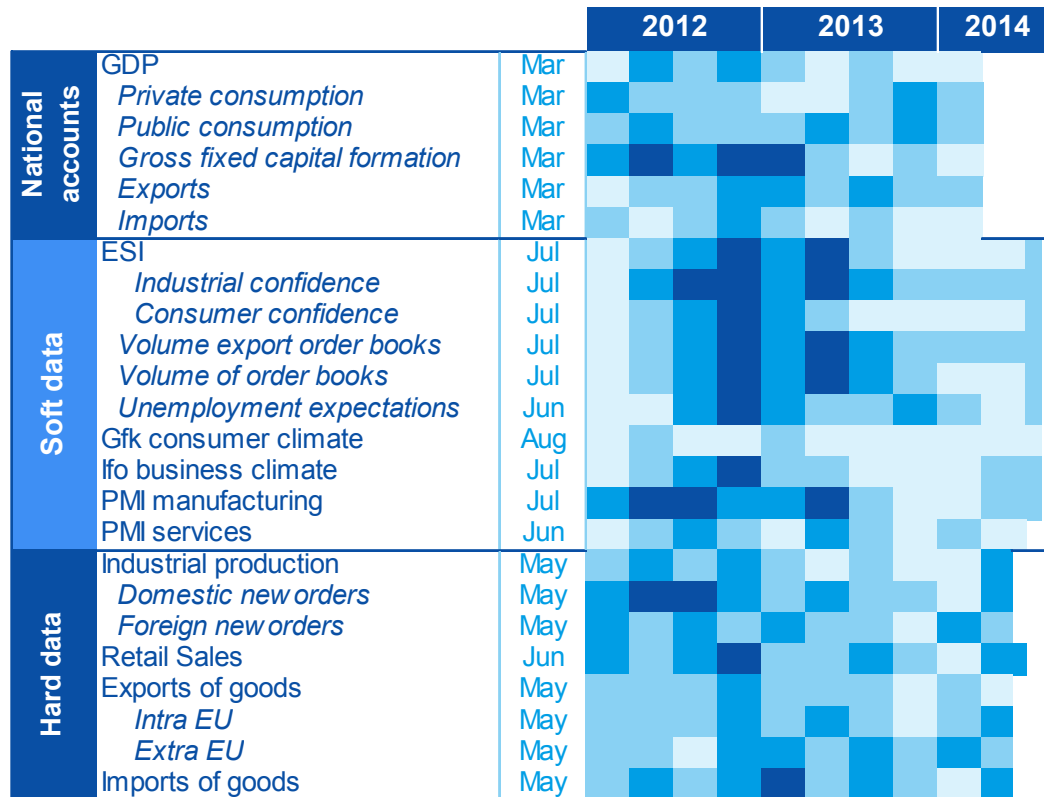
Section 4

Some imbalances have been corrected, but the growth potential is reduced

Annex

Country breakdown

Germany: internal fundamentals weight increasingly



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken. For confidence data, standardized values are used, and the growth and fall are related to the mean.



Confidence indicators peaked in Q1

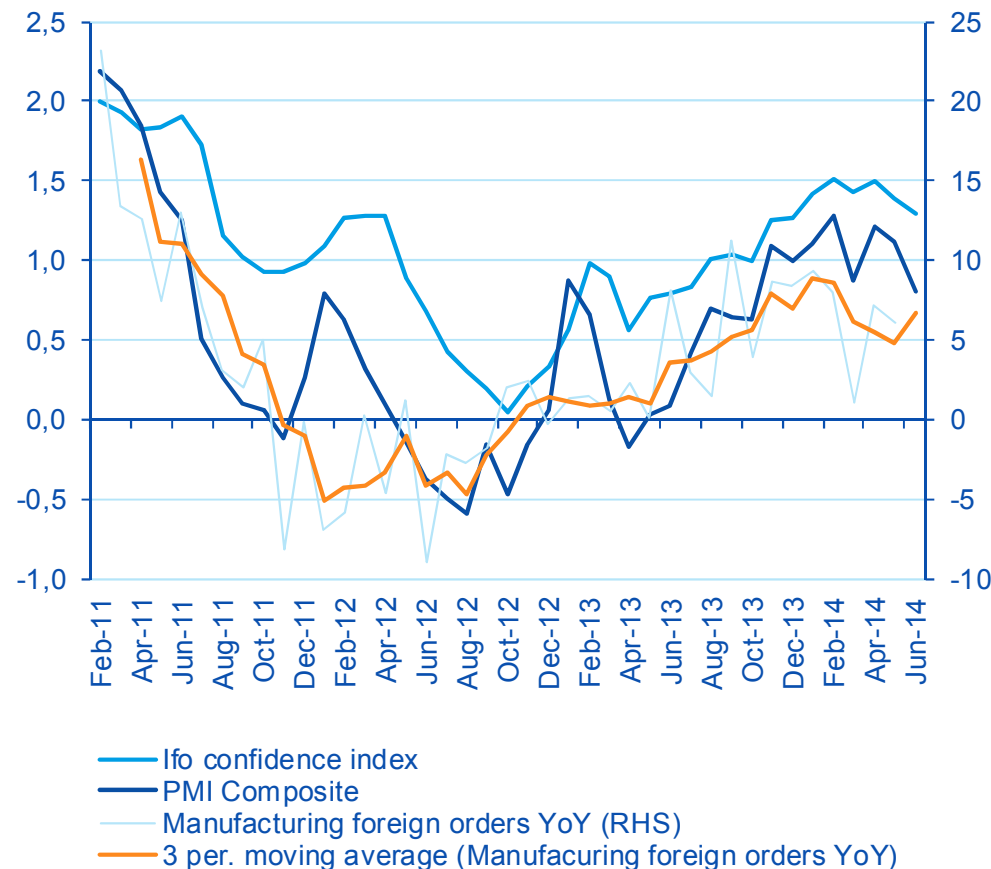
The growth is strong and the domestic demand role is increasing

	2012	2013	2014 (f)	2015 (f)
Economic activity				
REAL GDP (% YoY)	0.9	0.5	1.9	2.0
Private consumption	0.7	1.0	1.5	1.7
Public consumption	1.0	0.4	1.3	0.9
Investment	-1.3	-0.7	5.2	4.8
Domestic demand (contr. to %)	-0.2	0.5	2.1	1.9
Exports	3.8	1.1	3.5	4.0
Imports	1.8	1.6	4.4	4.5
External demand (contr. to %)	1.1	-0.2	-0.1	0.1
External sector				
Current account balance (% GDP)	7.0	7.5	6.7	7.0
Public finances				
General Govt. Balance (% GDP)	0.1	0.0	0.0	0.0
Prices				
CPI, % avg	2.1	1.6	0.9	1.5

Germany: sound growth with medium-term concerns

Ifo confidence, composite PMI and manufacturing orders from abroad

Source: BBVA Research

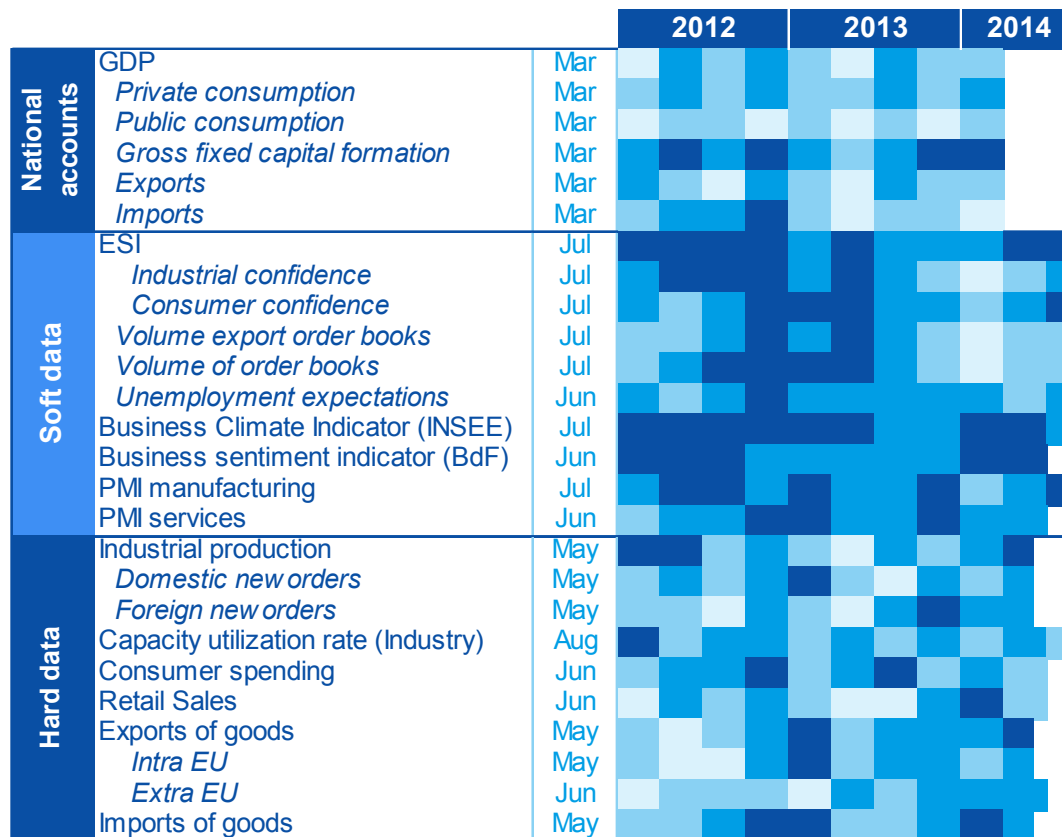


The growth rate is stronger and more balanced than in other major economies

But the recent approval of a higher minimum wage (8.50 €/h), effective from 2015, poses risks to medium-term employment

The liberalization of some services sectors would help boost consumption and domestic growth

France: recovery doesn't gain momentum



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken.
For confidence data, standardized values are used, and the growth and fall are related to the mean.

No DATA
Stronger growth
Growth
Fall
Deeper fall

Business confidence indicators stagnated in recent months

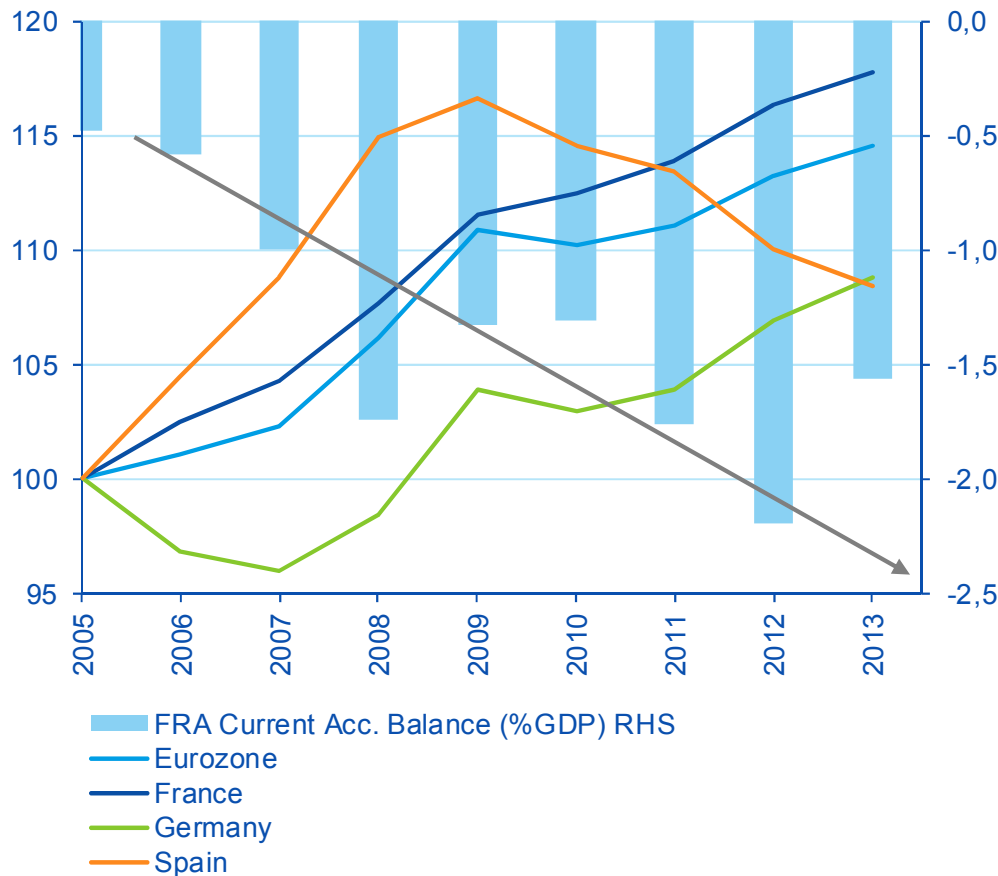
Domestic demand is the main driver of a sluggish recovery

	2012	2013	2014 (f)	2015 (f)
Economic activity				
REAL GDP (% YoY)	0.4	0.4	0.7	1.4
Private consumption	-0.4	0.3	0.5	1.2
Public consumption	1.6	1.9	1.1	0.5
Investment	0.3	-0.8	0.9	3.1
Domestic demand (contr. to %)	-0.2	0.3	0.7	1.3
Exports	1.2	2.4	2.7	3.2
Imports	-1.2	1.9	2.5	2.6
External demand (contr. to %)	0.6	0.1	0.0	0.1
External sector				
Current account balance (% GDP)	-2.3	-1.6	-1.7	-1.6
Public finances				
General Govt. Balance (% GDP)	-4.8	-4.3	-3.8	-3.0
Prices				
CPI. % avg	2.2	1.0	0.7	1.0

France: reforms needed to increase competitiveness

Unit labour costs and current account balance

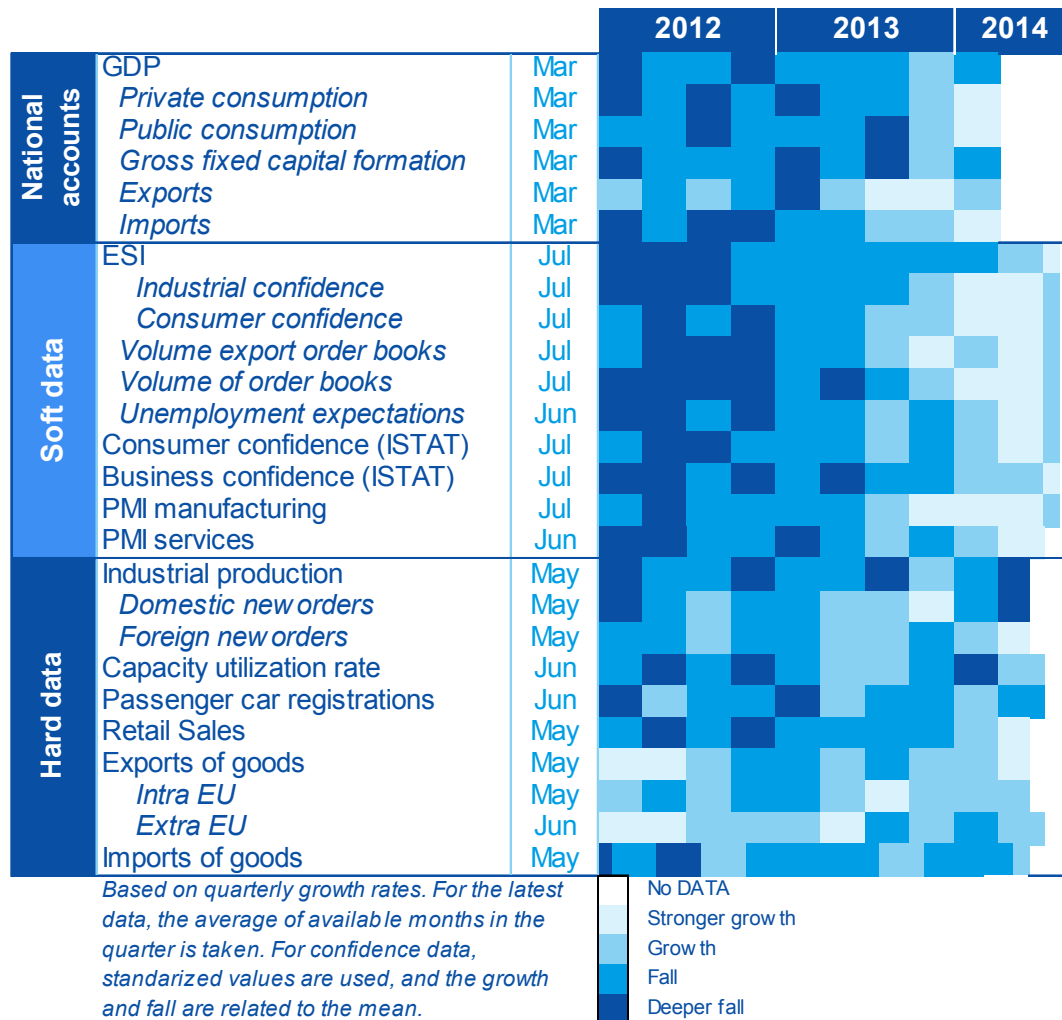
Note: Unit labour costs normalized to 100 in 2005
Source: BBVA Research



The loss of competitiveness is the main issue in the medium term

Therefore, cuts are expected in the tax burden on employment to be financed by lower public spending

Italy: exports support the slow recovery



The recent confidence indicators are clearly more positive

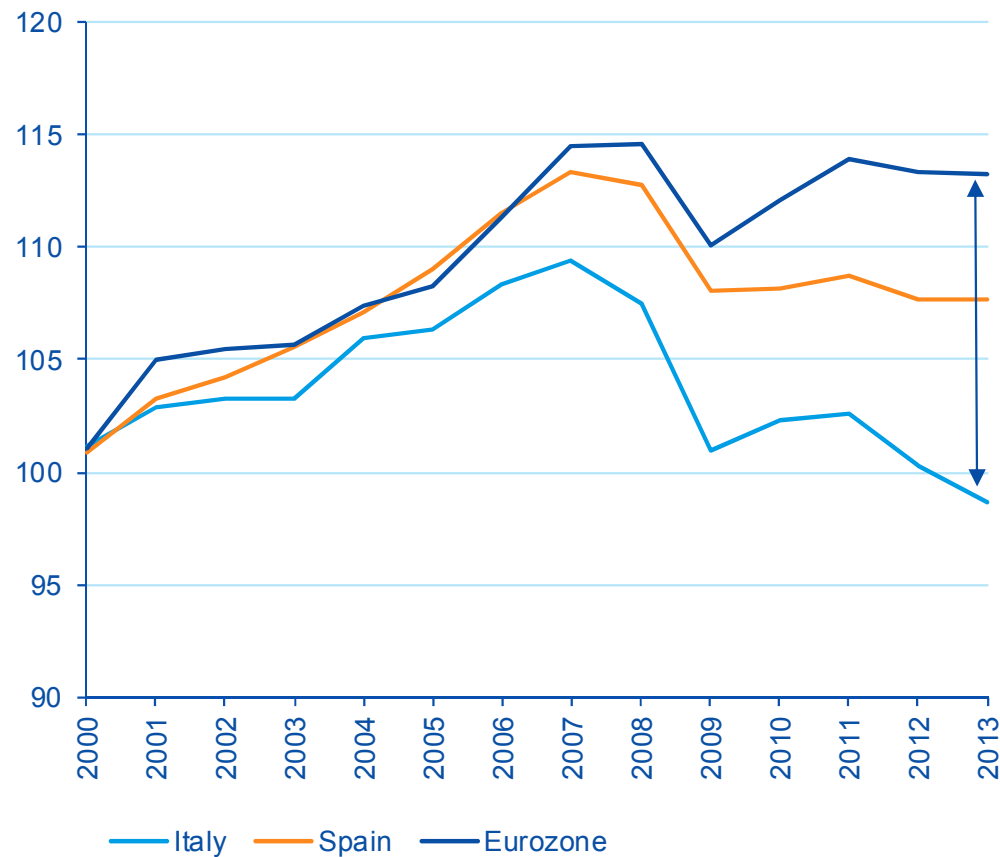
Out of recession from 4Q13, in the path of recovery driven by exports

	2012	2013	2014 (f)	2015 (f)
Economic activity				
REAL GDP (% YoY)	-2.4	-1.8	0.3	1.3
Private consumption	-4.0	-2.6	0.0	0.8
Public consumption	-2.6	-0.8	-0.6	0.5
Investment	-8.1	-4.6	0.3	3.3
Domestic demand (contr. to %)	-5.0	-2.6	-0.1	1.1
Exports	2.0	0.0	2.8	3.7
Imports	-7.1	-2.9	1.6	3.5
External demand (contr. to %)	2.6	0.8	0.4	0.2
External sector				
Current account balance (% GDP)	-0.7	0.8	1.1	0.9
Public finances				
General Govt. Balance (% GDP)	-2.8	-3.0	-2.7	-2.2
Prices				
CPI, % avg	3.3	1.3	0.4	0.9

Italy: reforms needed to increase the growth potential

GDP/working age population (2000=100)

Source: BBVA Research

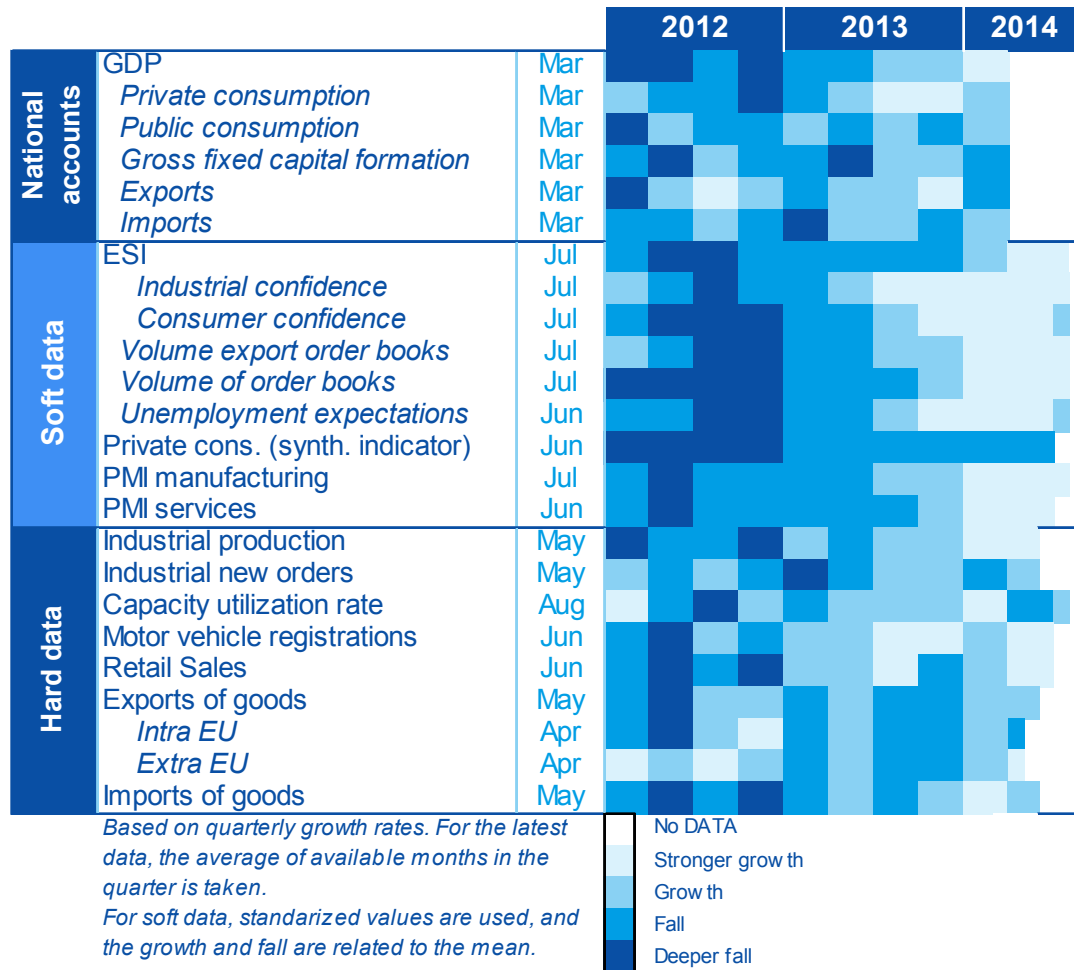


In fiscal policy, the main problem is the high volume of public debt (132.6%), while the deficit seems to be under control (-3%)

The very slow growth potential reflects the lack of reforms over a long period

Many reform initiatives have been launched, but need to be defined

Spain: the recovery is gaining momentum



Both soft and hard indicators have gained momentum in early Q2

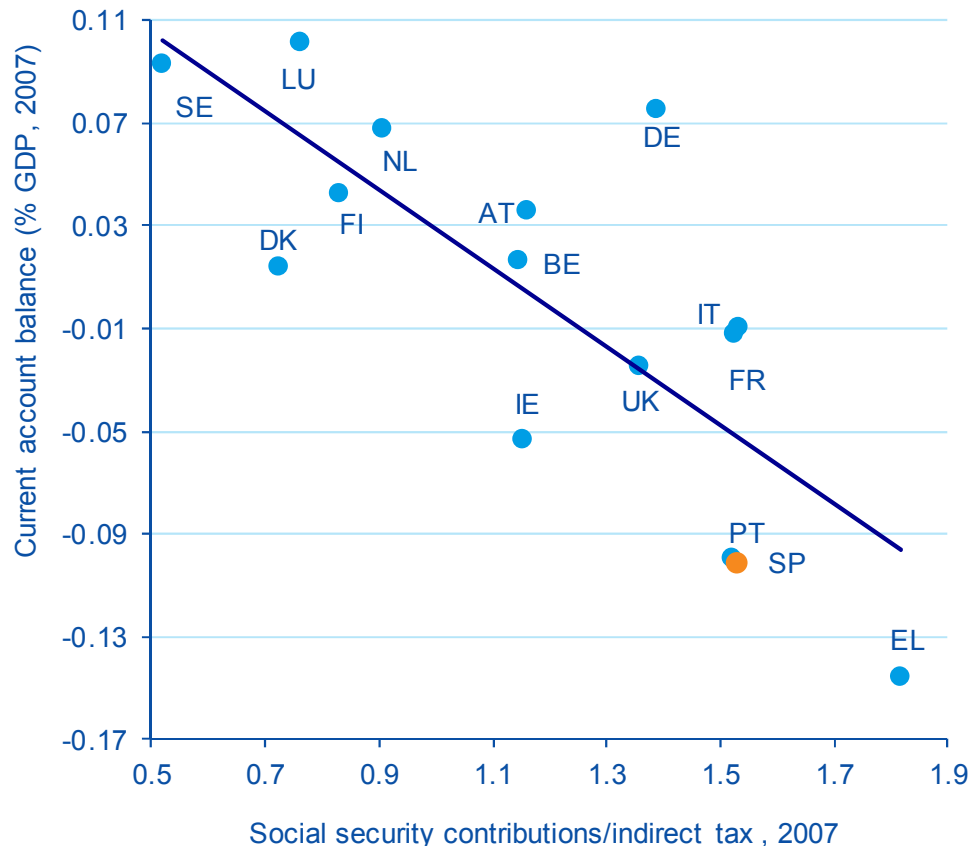
Growth forecasts are 1.3% and 2.3% in 2014 and 2015, with an upward bias this year

	2012	2013	2014 (f)	2015 (f)
Economic activity				
REAL GDP (% YoY)	-1,6	-1,2	1,3	2,3
Private consumption	-2,8	-2,1	1,9	2,0
Public consumption	-4,8	-2,3	0,1	0,6
Investment	-7,0	-5,1	1,2	4,9
Domestic demand (contr. to %)	-4,1	-2,7	1,4	2,2
Exports	2,1	4,9	4,7	6,5
Imports	-5,7	0,4	5,1	6,4
External demand (contr. to %)	2,5	1,5	0,0	0,2
External sector				
Current account balance (% GDP)	-1,1	0,9	0,3	1,1
Public finances				
General Govt. Balance (% GDP)	-6,8	-6,6	-5,5	-4,5
Prices				
CPI, % avg	2,4	1,4	0,1	0,9

Spain: reforms are needed to reduce unemployment and strengthen the increasing competitiveness

UE 15: current account balance and implicit rates of contribution to Social Security

Source: BBVA Research from Boscá, Doménech y Ferri (2013)



Fiscal devaluation: the optimal alternative

The recent cut of contributions to the Social Security (CSS) will have a positive effect on GDP and employment ...

... but will be limited due to the temporary nature of the measure (among other factors)

A fiscal devaluation (increase of indirect taxes + reduction of CSS) could improve the price-competitiveness, employment and activity