

BBVA Research Global Outlook

## Challenges ahead for a sustained recovery

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Second quarter 2010

18th May 2010

**Two conflicting forces are leading the world economy:** The positive cyclical impulse from emerging countries and the US and heightened risk premia spreading from Europe. However, the EU rescue package reduces uncertainties in the short-run.

**The sustainability of the recovery is not fully guaranteed beyond 2010:** The fiscal and monetary policies have been particularly instrumental in providing impulse to the cyclical upturn. However, as expansionary policies fade away, doubts beyond 2010 are growing, particularly in advanced economies.

**There exists a wide heterogeneity of cyclical conditions, and, consequently, exit strategies will differ:** Gradual approach in the US, unclear exit timing for the EMU, and no one-size-fits-all strategy across emerging markets.

**The process of fiscal consolidation is uncovering the weaknesses of the European economy, but contagion is not fully justified:** The heightened stock of public and private debt in some economies will push up real rates, making these economies vulnerable to upward movements in interest rates and higher risk premia.

**The lack of a decisive restructuring in the banking sector and the coming regulatory process might jeopardize the recovery:** The sluggish restructuring of the financial industry will lead to a creditless recovery. The most likely outcome for the ongoing regulatory reform is one of a significant increase in capital and liquidity requirements. This is a growing concern since empirical evidence show the importance of the credit channel in the early stages of an economic recovery.

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Two conflicting forces leading the world economy

Section II

The sustainability is not fully guaranteed beyond 2010

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Growing divergence in monetary exit strategies

Section IV

Markets show the limits of countercyclical fiscal policy

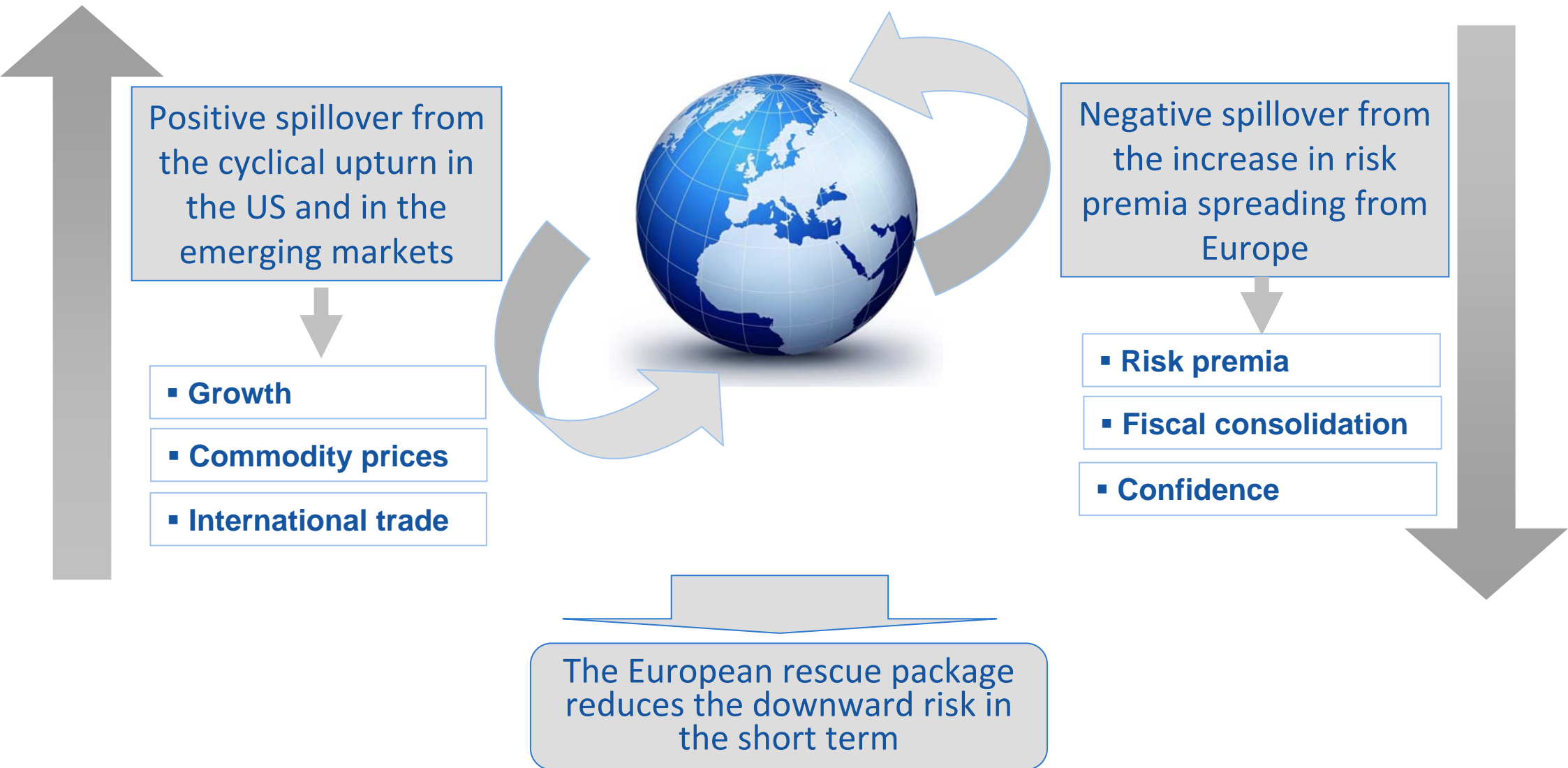
Section V

Long-run fiscal consolidation is the major challenge

Section VI

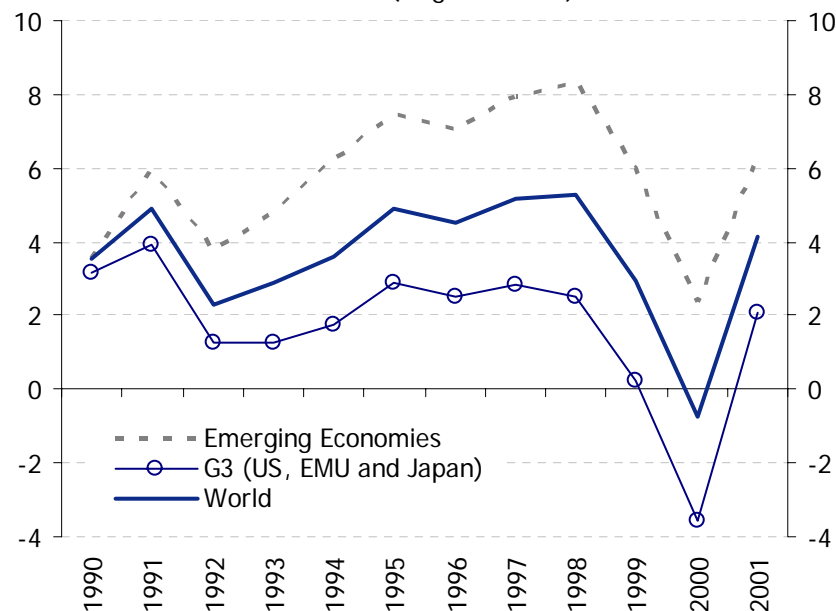
From sluggish restructuring to creditless recovery

The global economy is driven by two conflicting forces



### Positive spillover from the cyclical upturn in the US and Emerging markets

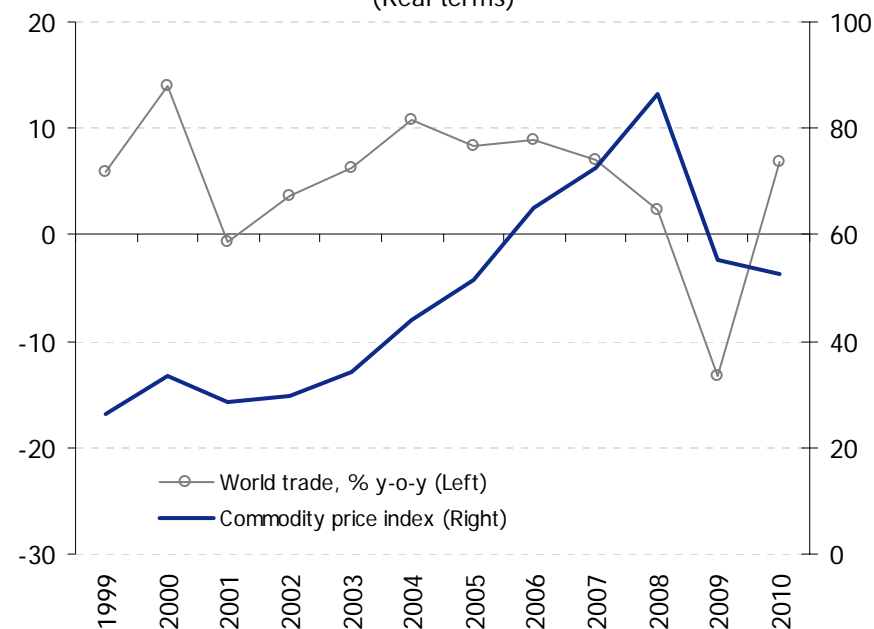
**Emerging Economies and G3: GDP Growth** (% growth rate)



Source: BBVA Research

World economy is expected to grow at around 4%

**Trade and commodity prices** (Real terms)



Source: BBVA Research using CPB data

Trade is growing at 7% and commodity prices remain at high level

Positive spillover from the cyclical upturn in the US and Emerging markets

### Europe

2009: -4.0%



2010: 0.7%



### Asia

2009: 1.8%



2010: 5.8%

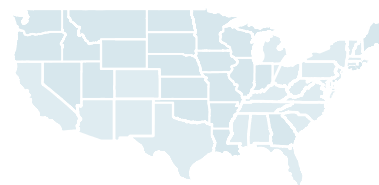


### USA

2009: -2.4%



2010: 3.0%



### Latin America

2009: -2.5%



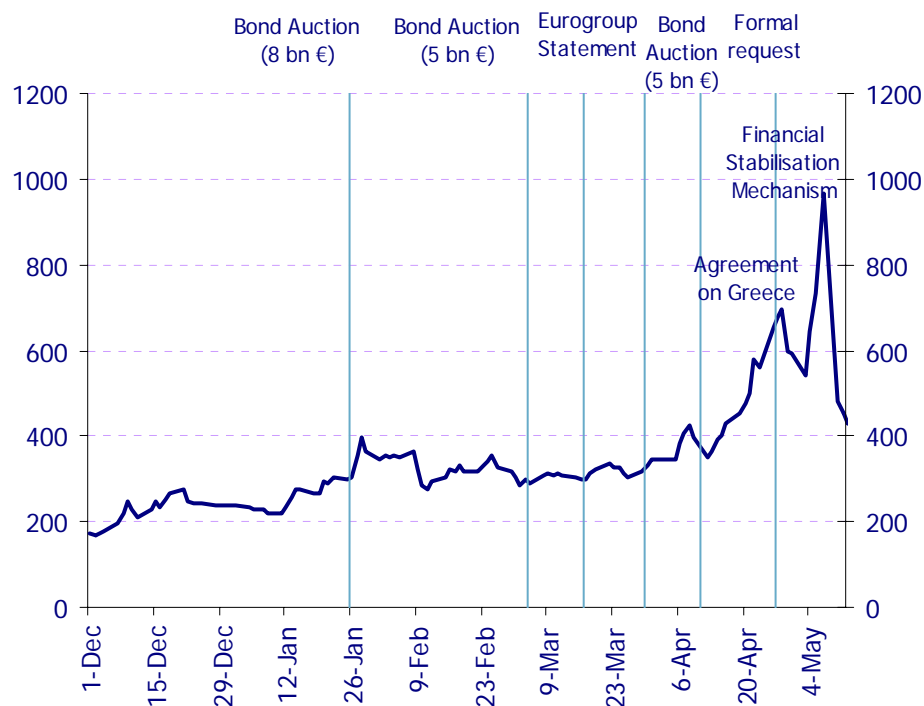
2010: 4.6%



However, regional heterogeneity remains as a key feature of the outlook, with the EMU lagging behind other areas.

### Negative spillover from the increase in risk premia spreading from Europe

**Greece: 10-yr Sovereign bond spread (bps)**



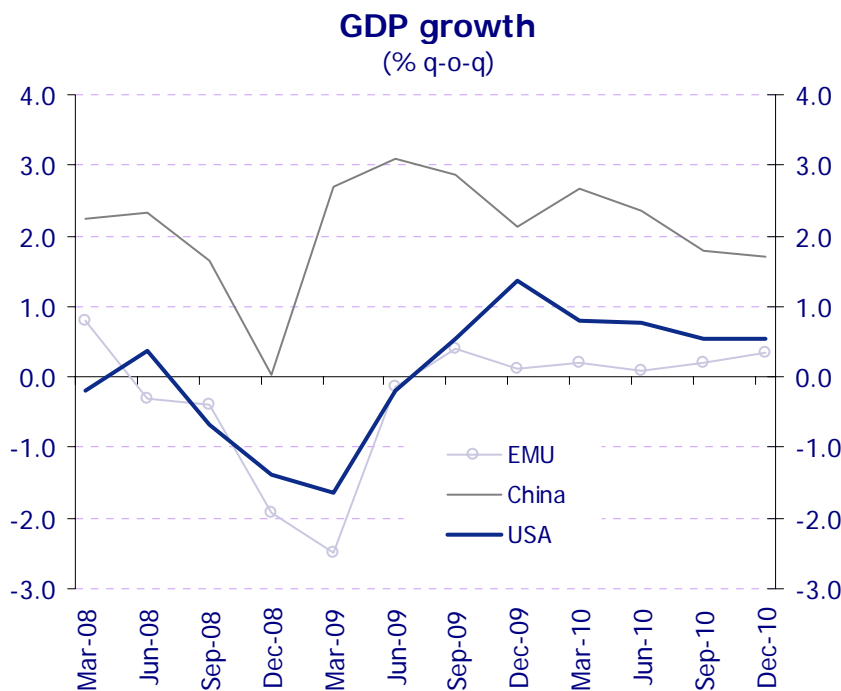
Source: Bloomberg and BBVA Research

The new EU stabilization mechanism is an intelligent and satisfactory response to generate fiscal discipline.

However, uncertainties remain on three fronts:

- The implementation of the rescue package in the months to come.
- The credibility of further fiscal consolidation yet to be adopted by some EU countries.
- The EMU core countries' medium-term commitment to the package.

**While economic recovery at the beginning of 2010 is widespread, its intensity varies a great deal across countries.**

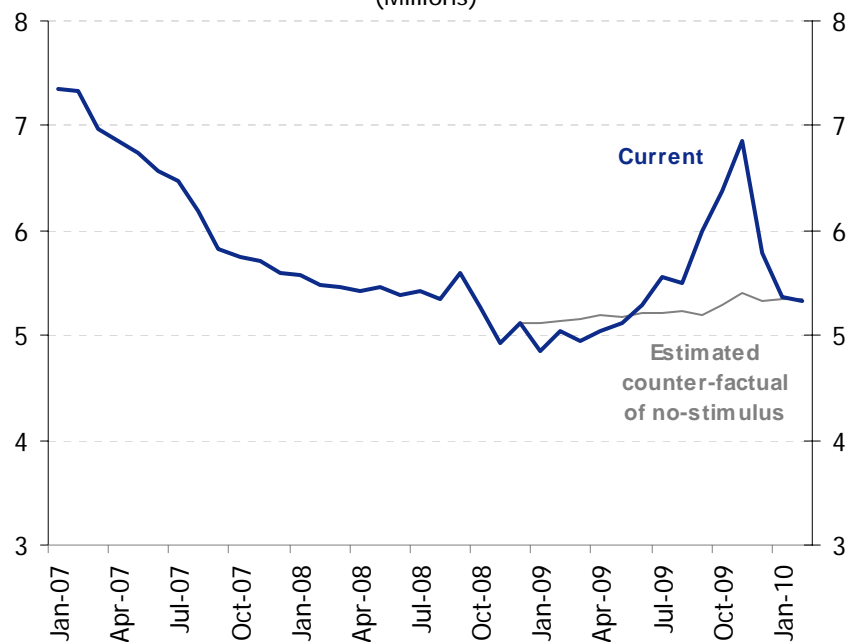


Source: BBVA Research

**Following the short-term impulse from unprecedented fiscal and monetary expansion worldwide, the sustainability of the recovery is not fully guaranteed beyond 2010.**

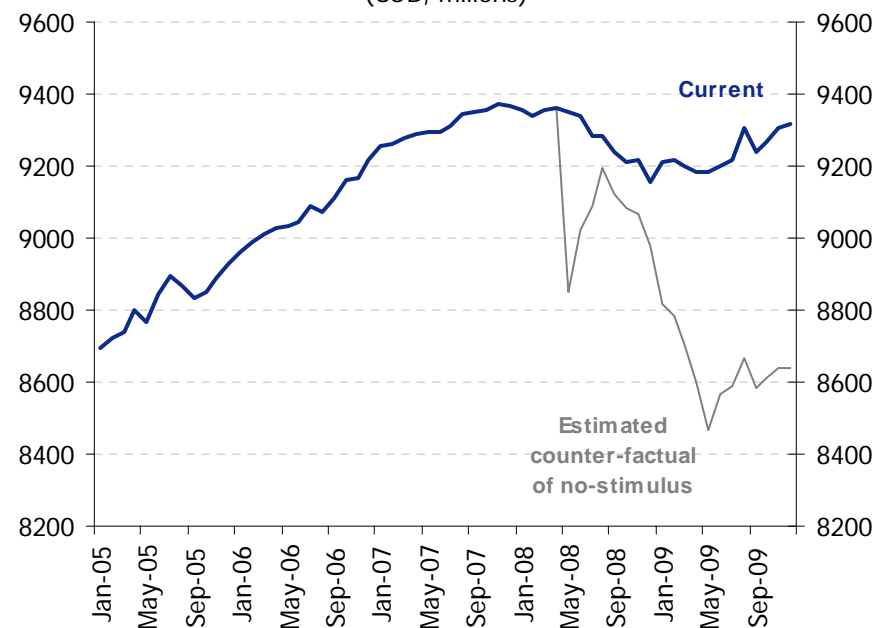


**US: Home Sales**  
(Millions)



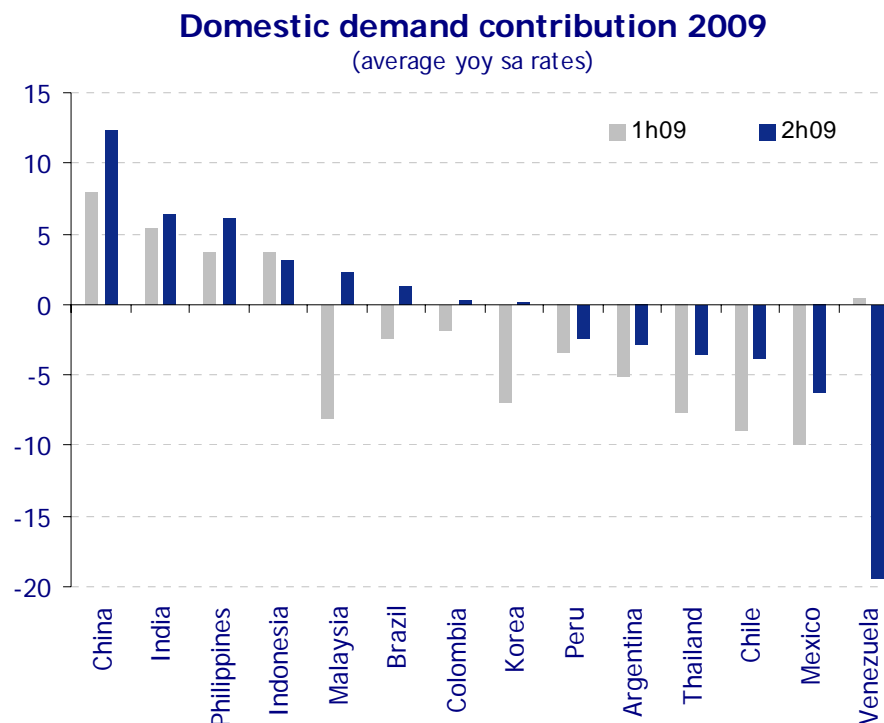
Source: BBVA Research

**US: Real Personal Consumption**  
(USD, millions)



Source: BBVA Research

**This is the result of the different degrees to which their fiscal and monetary policies have been eased. However, as expansionary policies fade away, doubts about the sustainability of the recovery beyond 2010 are growing in the developed countries.**



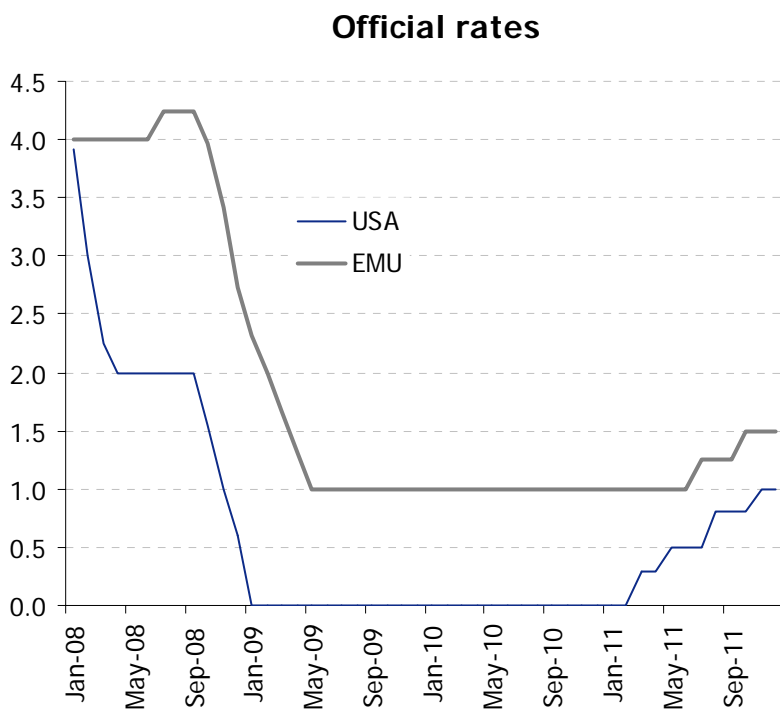
Source: BBVA Research

**On the contrary, Asian economies are benefiting from stronger domestic demand. LATAM countries' domestic demand is recovering. In these economies the recovery looks more sustainable.**

- US: Very gradual path of interest rates hikes.

- EMU: No clear timing for the exit.

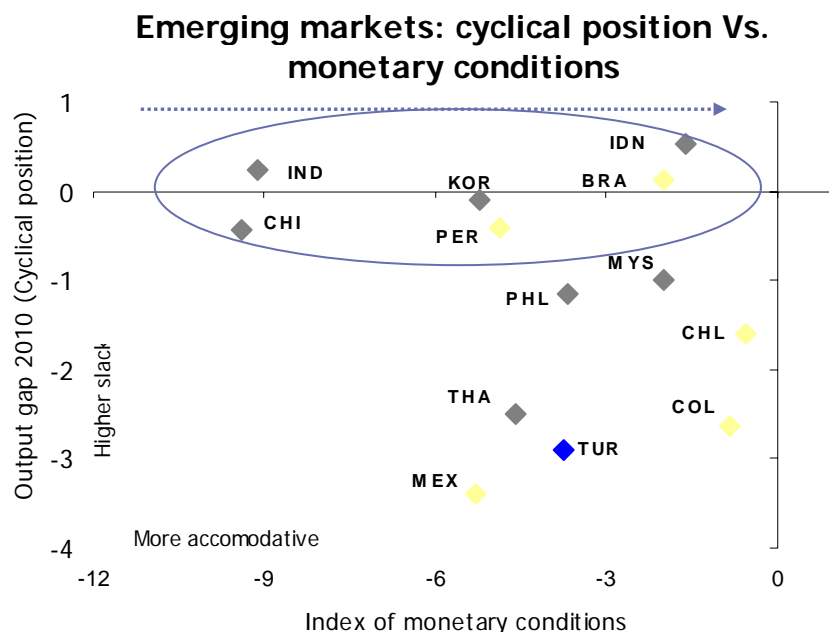
- Emerging: No 'one size fits all' strategy.



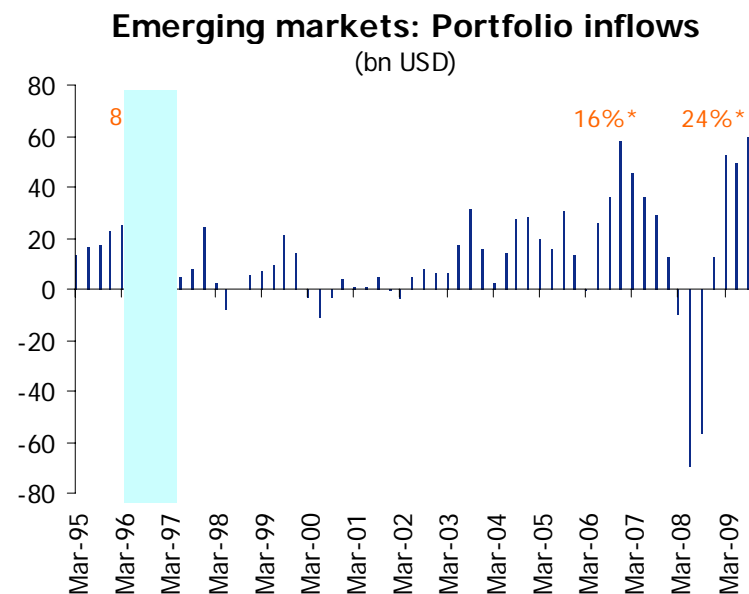
Source: BBVA ERD

- Although economic growth may prove sluggish in 2010 and later, the risk of a major reversion of the current dynamics is rather limited in the US, with incipient inflationary pressures looming.

- Conversely, in Europe, in addition to a far more fragile financial situation, the upturn looks more uncertain and inflationary pressures are absent.



Note: Countries within the circle show excessively accommodative monetary conditions given their OG levels. A more restrictive stance is advised particularly on these cases.



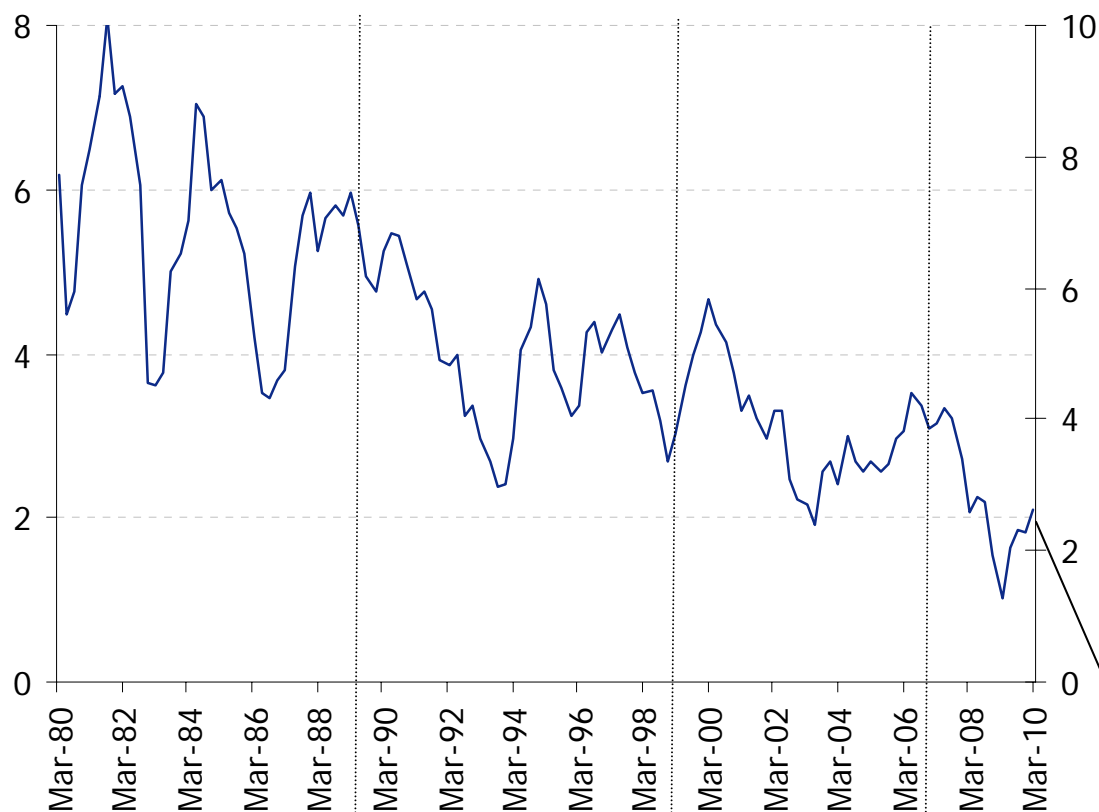
Source: IFS and ERD BBVA

\* The value is the maximum appreciation registered during the flow surge period (simple average between key emerging countries: Argentina, Brazil, Mexico, Colombia, Chile, Peru, Venezuela, China, India, Indonesia, Malaysia, Korea, Thailand, Poland, Russian and Turkey).

In the case of emerging economies there is no doubt about the need for a tightening stance, though exit strategies will vary across countries. In some countries, if the tightening of monetary policy and other measures are not implemented soon, imbalances will build up.

**Economies with high public debt and limited private deleveraging are highly vulnerable to an upward movement in interest rates and higher risk premiums.**

**US: real interest rates**



Source: BBVA Research

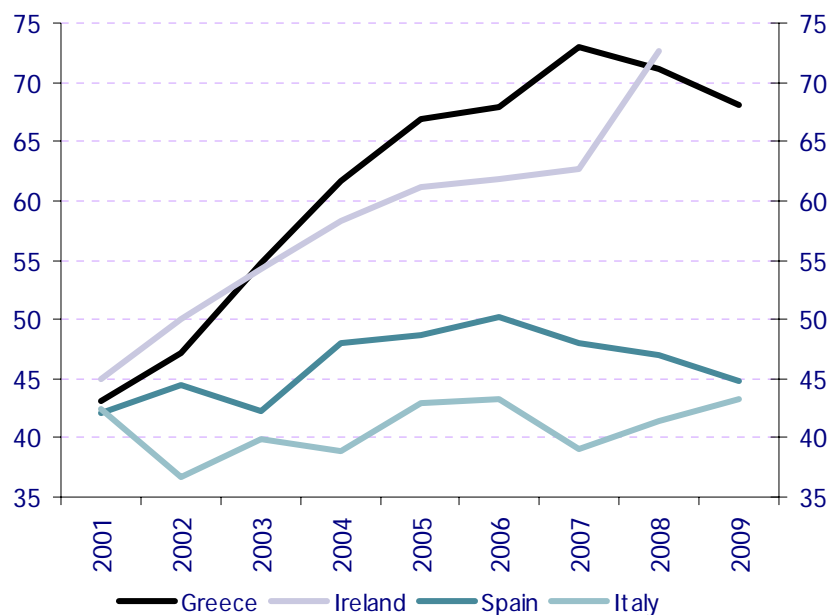
As a % of GDP	1980-1989	1990-1999	2000-2006	2007-2009	Current
Public debt	53.3	68.6	58.8	72.5	84.5
Private debt	106.2	139.0	184.6	202.0	193.7

Source: BBVA Research

A clear result of the current fragility is the contagion to other countries

However, the contagion is not fully justified either by the direct financial channel or by fundamentals.

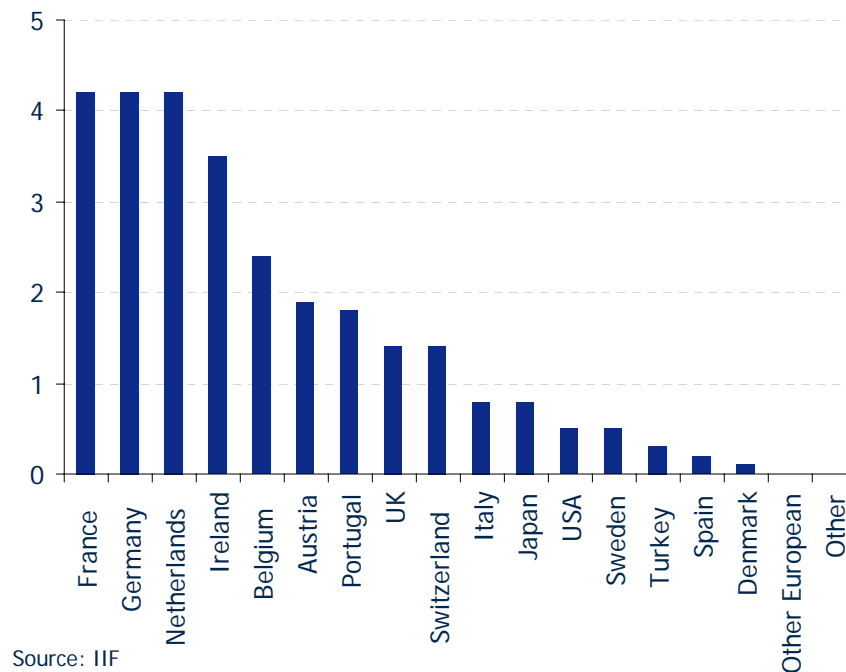
**General government debt held by non-residents (percentage)**



Source: Central Banks and BBVA ERD

A substantial portion of the Greek debt is held by non-resident investors, whereas Spain and Italy exhibit a higher home bias.

**Banks exposure to Greek debt (% banks' capital)**



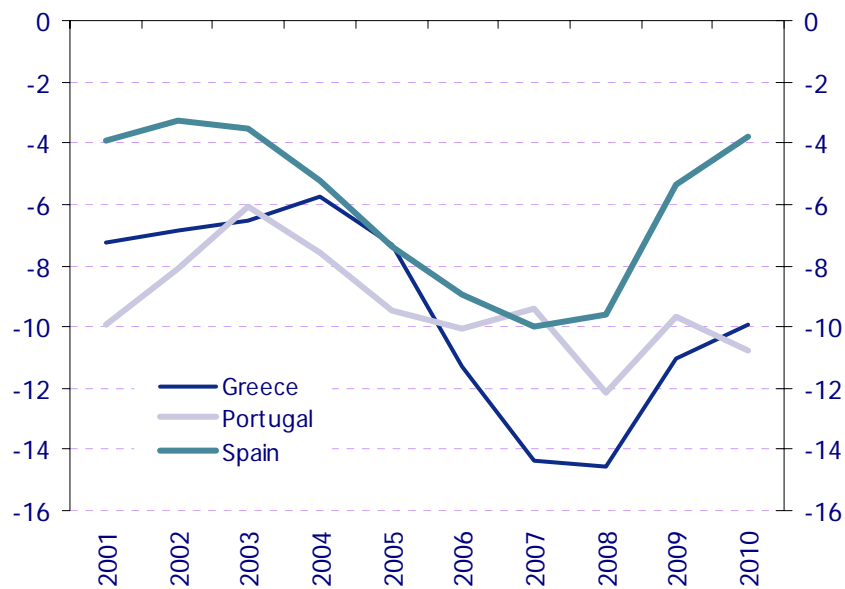
Source: IIF

The international exposure to Greek risk exhibits significant differences across countries.

A clear result of the current fragility is the contagion to other countries

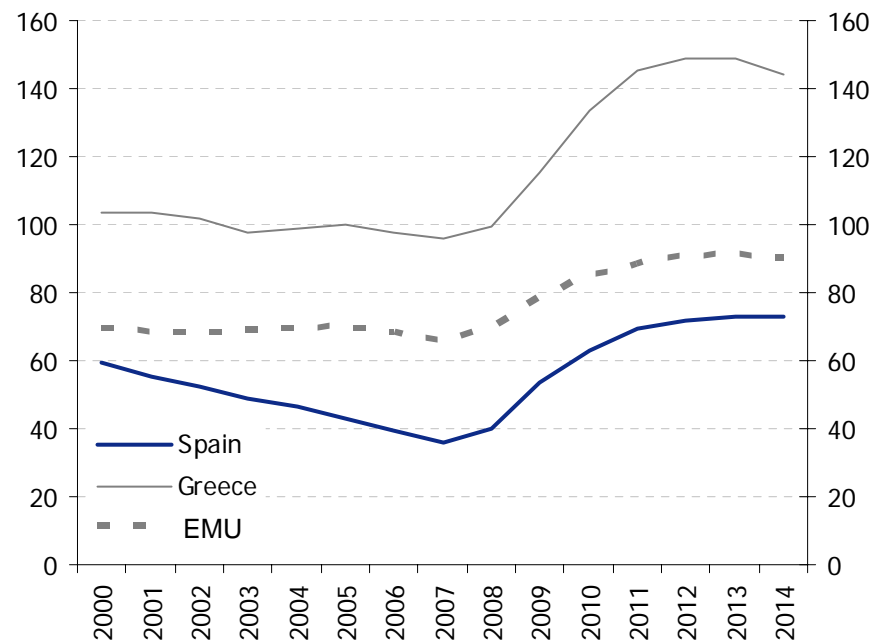
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**Current account balance**  
(% of GDP)



Source: Datastream

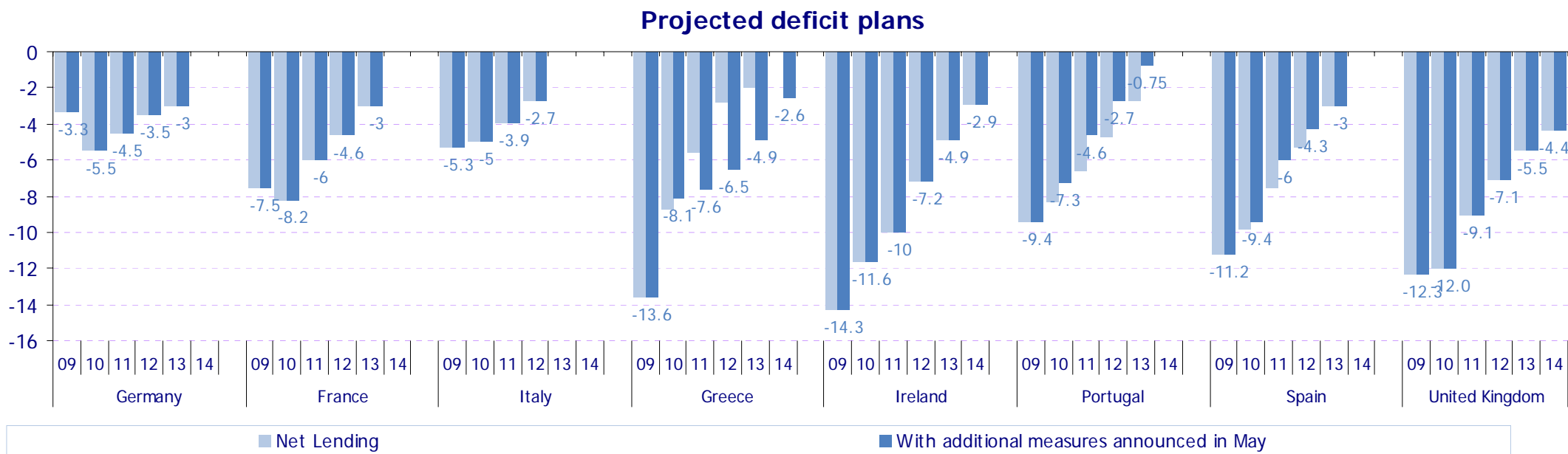
**Public debt as a % of GDP**



Source: Eurostat and BBVA Research

**Problems of the Spanish economy are far less acute. Its exports share has increased, and the adjustment of the current account deficit is quite impressive.**

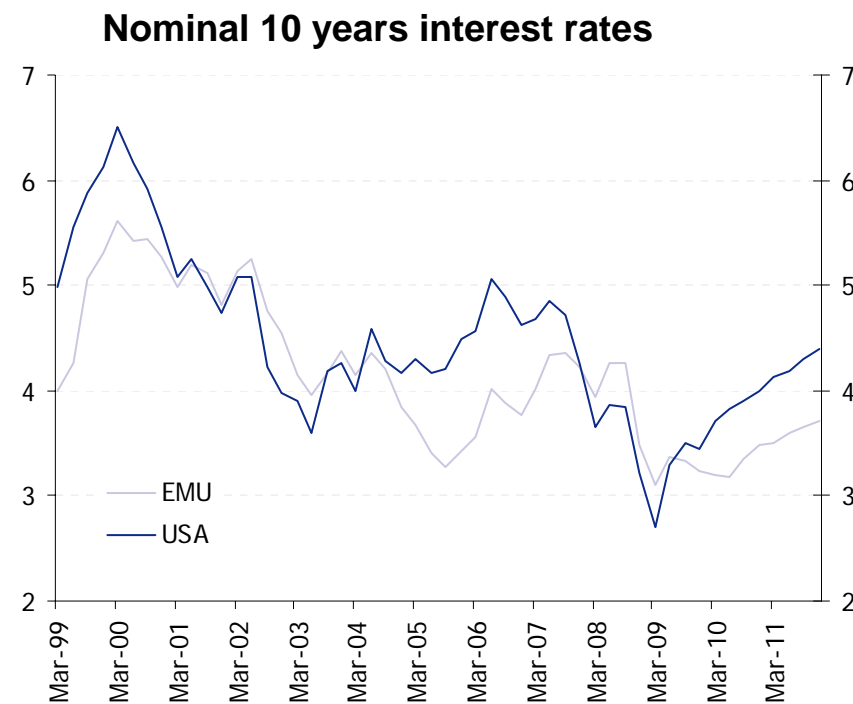
There are growing concerns about the long-run consequences of rising public debt levels.



Source: National Government to EC January 2010, announcement in May and CBO for the US



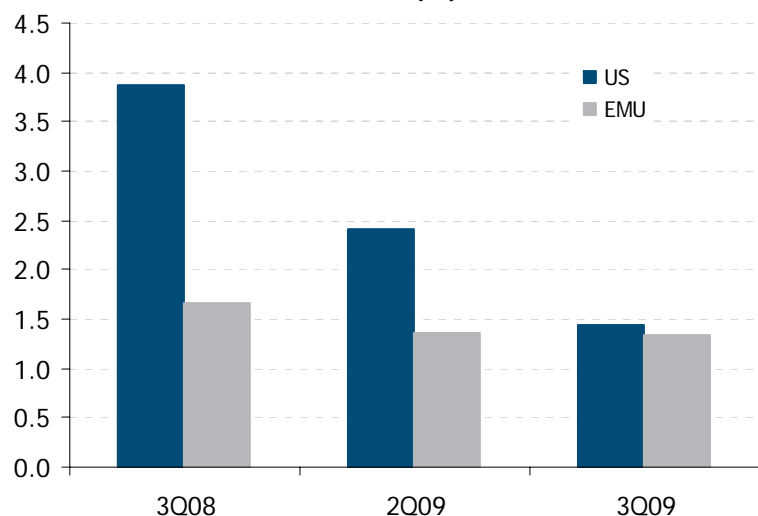
**This will inevitably give rise to upward pressures on real interest rates and increase risk premiums for a protracted period.**



Source: BBVA Research

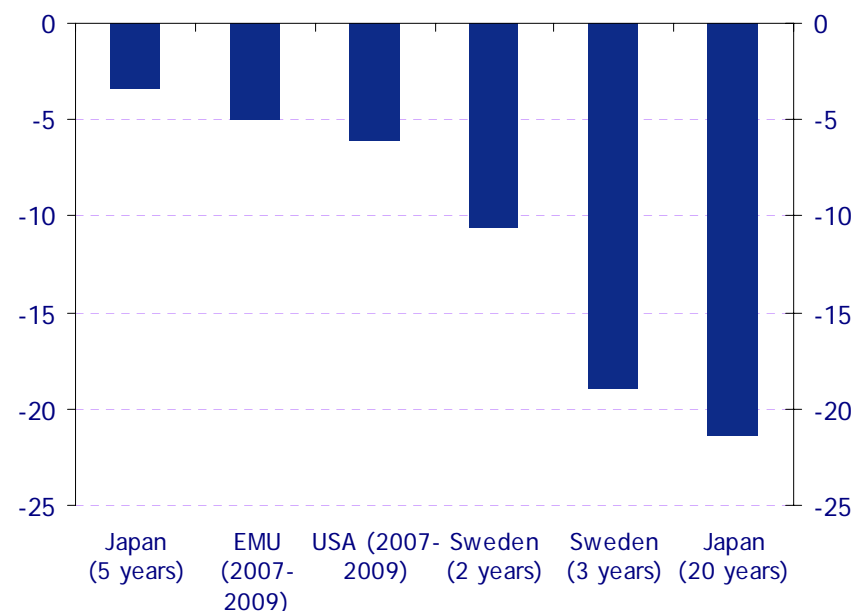
The sluggish restructuring of the financial industry, particularly in Europe, will lead to a creditless recovery. The most likely scenario is a low restructuring.

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

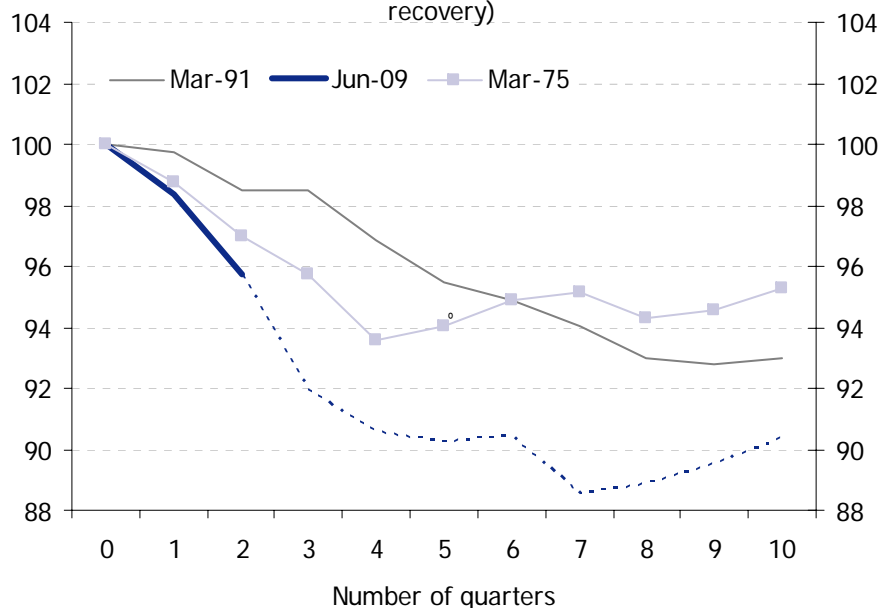
Japan = City banks and Regional banks

USA = Registered institutions in FDIC

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

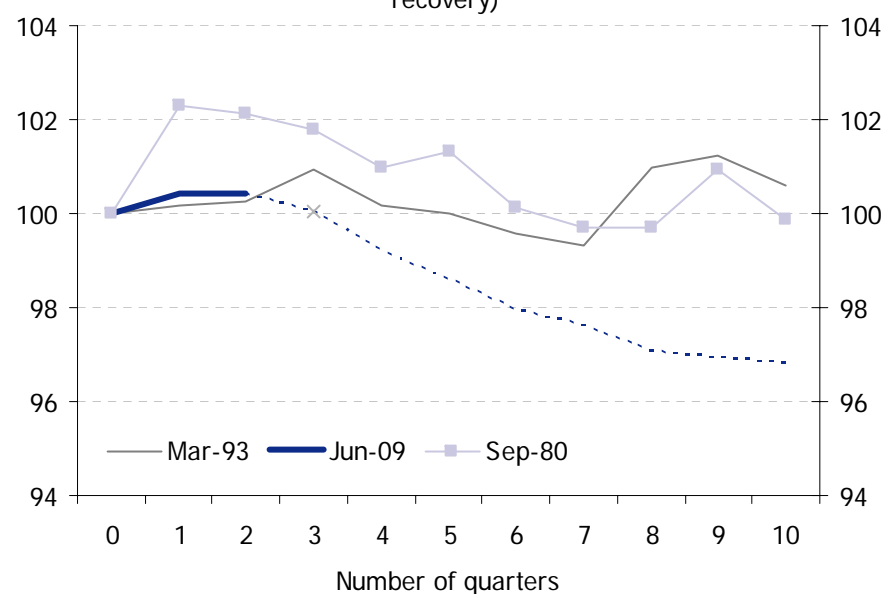
The sluggish restructuring of the financial industry, particularly in Europe, will lead to a creditless recovery.

**USA: Real total credit over GDP in different cycles** (=100 at the beginning of each recovery)



Source: BBVA ERD, based on BEA and Fed

**EMU: Real total credit over GDP in different cycles** (=100 at the beginning of each recovery)



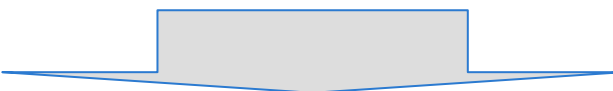
Source: BBVA ERD based on Eurostat and ECB

According to our estimates, the credit channel will not boost the economy in the current cycle, and the credit over GDP ratio will continue decreasing in the coming quarters, more intensively than in any other cycle.

**There is also a high degree of uncertainty regarding the ongoing regulatory reform**

Our central scenario encompasses some elements that minimise the potential risks of the reform. In particular, this scenario relies on the leading role of the Financial Stability Board (FSB).

The most likely outcome is one requiring significant increases in capital and liquidity requirements. This could hinder the ability of the banking sector to provide credit in the coming years.

**Main concerns:**

- A fragmentation in the phase of implementation.
- Break of the global framework of decision could undermine the level-playing field.
- Over-regulation, with a menu of different measures alongside Basel 3, will impinge credit markets.

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