

Awaiting a solution to the European crisis

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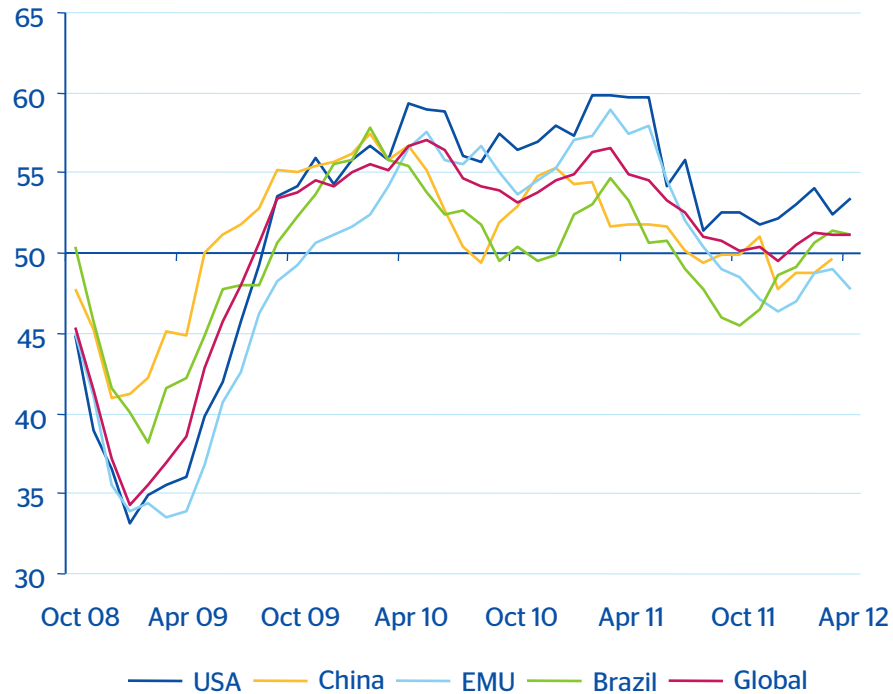
1 Global economic outlook

2 Awaiting the solution to the European debt crisis

The world economy has survived the major recession of 2008

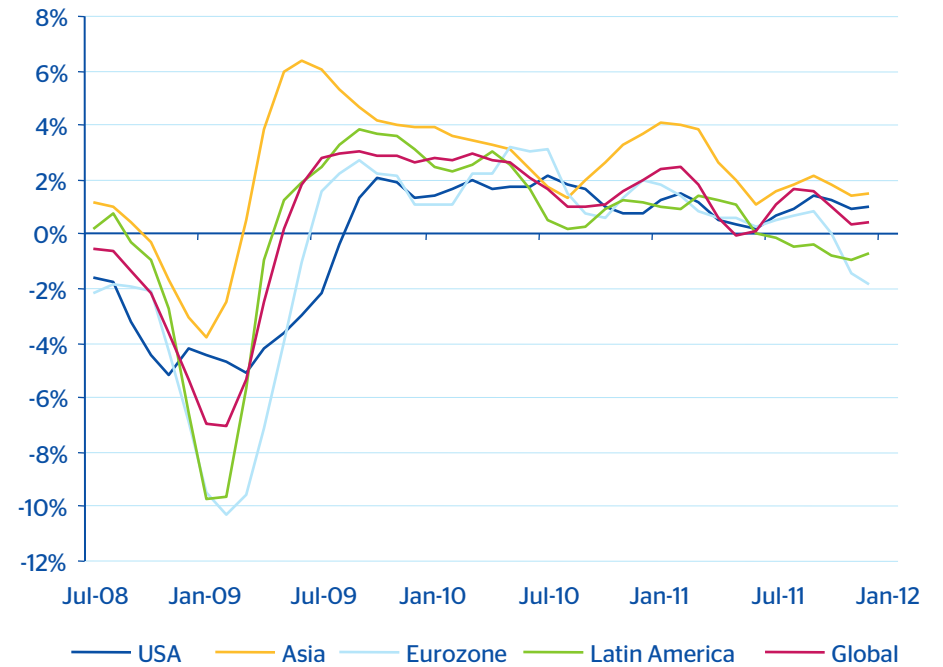
Business expectations (PMI)

Source: BBVA Research and Bloomberg



Industrial output (% qoq of 3 month moving average)

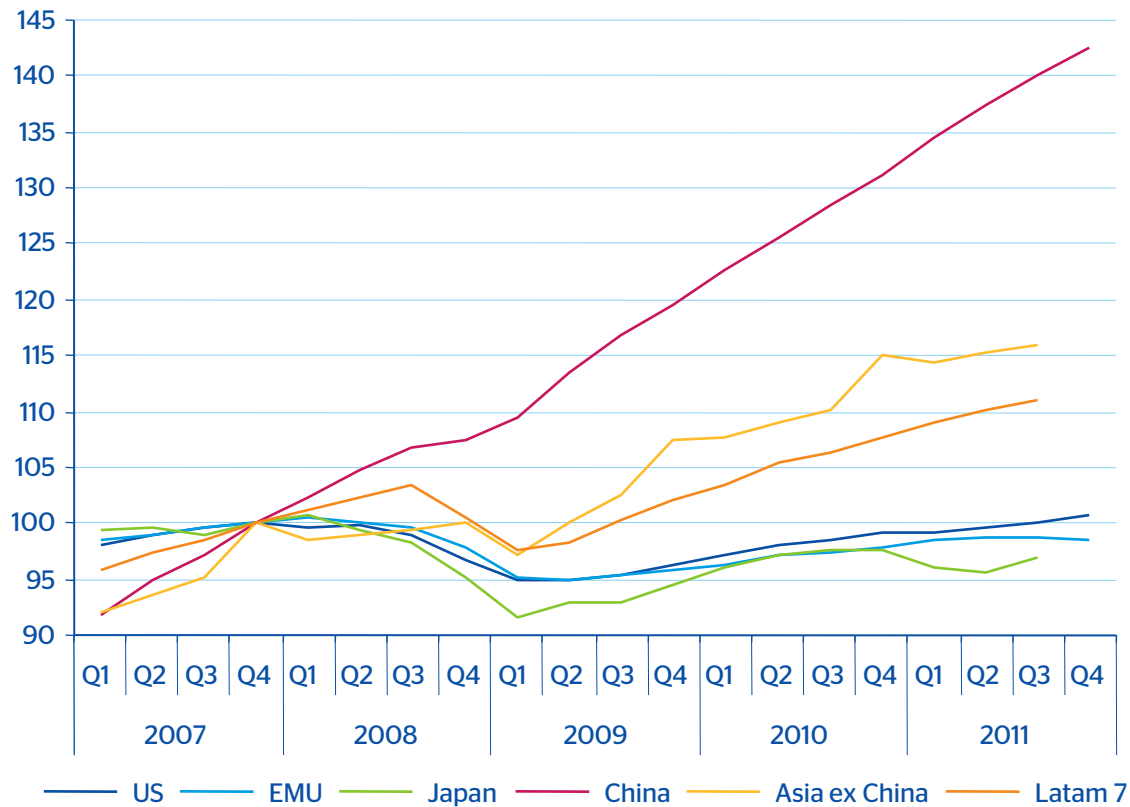
Source: BBVA Research, CPB and national sources



But with major differences between developed and emerging countries

GDP (Q4 2007 = 100)

Source: BBVA Research

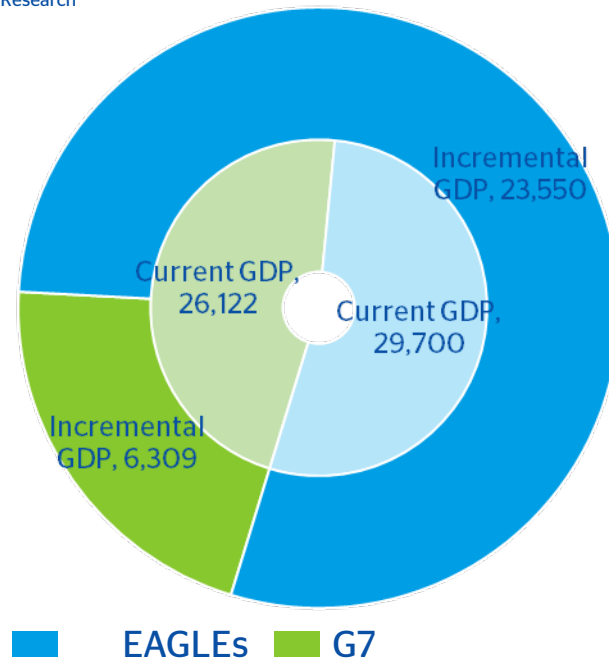


Emerging economies responsible for much of global growth

EAGLEs (Emerging and Growth-Leading Economies) will continue to lead growth over the next decade.

EAGLES vs. G7: current size and “incremental business”

Source: BBVA Research

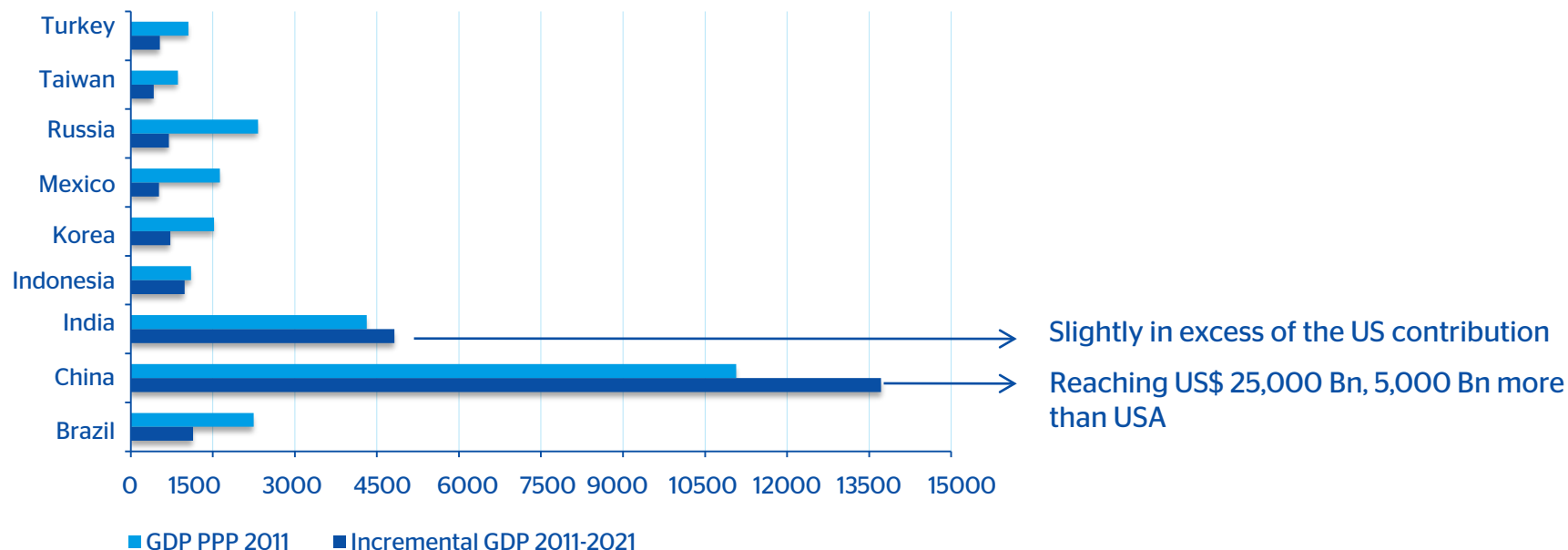


EAGLES[©]

Global growth will be lead by: China and India will contribute more than the USA; Korea and Indonesia more than Russia; Mexico, Egypt, Taiwan and Turkey more than the G6 average

EAGLES[©]: Current size and contribution to global growth 2011-2021

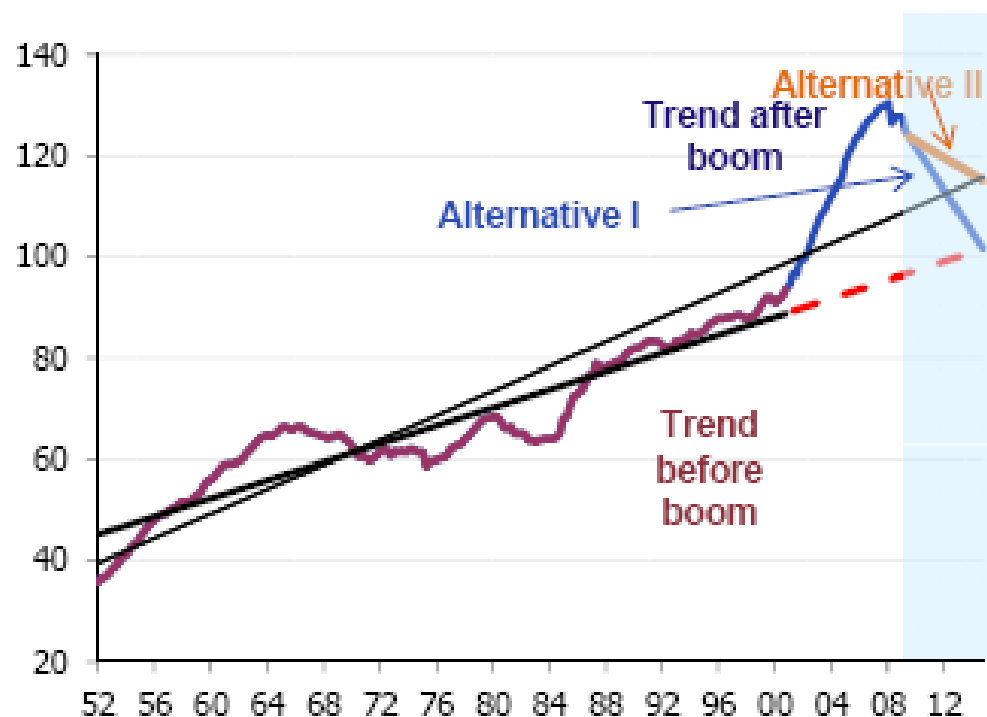
Source: BBVA Research



Advanced economies need to deleverage...

US: Debt to income ratio

Source: BBVA Research



The increase in debt was largely due to real estate expansion (USA, UK, Spain, Ireland)

Deleveraging will impact on domestic demand whilst households and companies reestablish their financial position

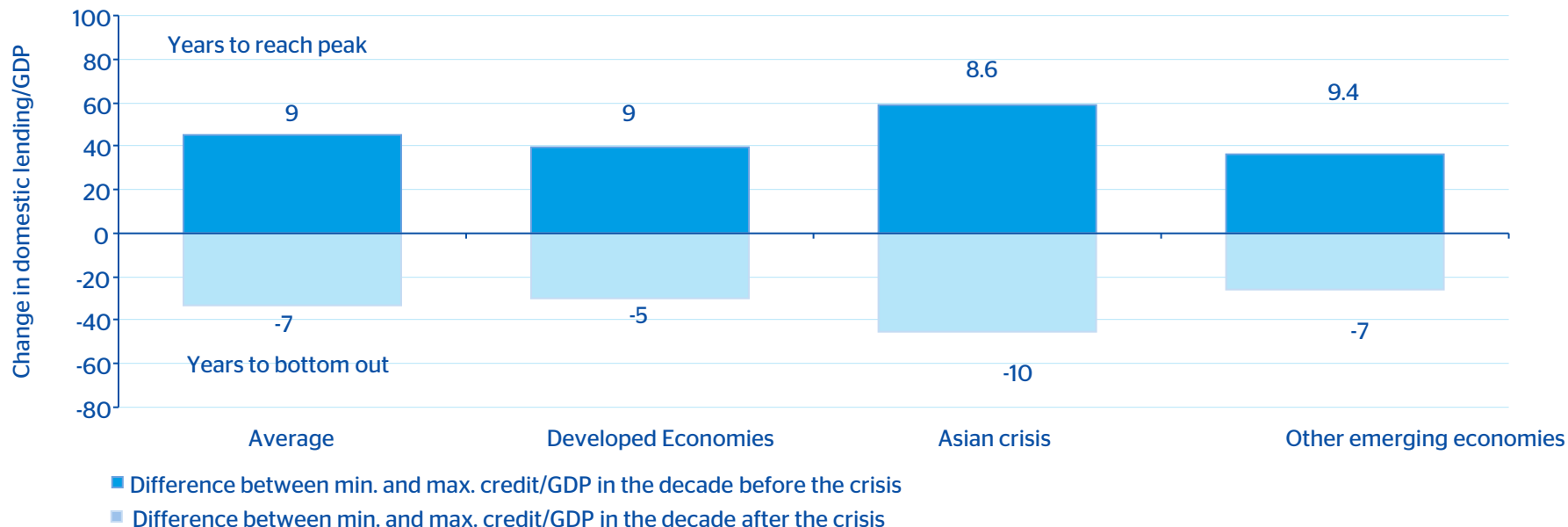
Structural reforms are essential for a return to growth, which is hampered by weak demand

... The deleveraging process is usually long and painful

Deleveraging is often a long process, lasting 7 years on average. This involves both lack of capacity to grant credit and low demand for loans

Domestic bank lending/GDP in the 10 years before and after a serious financial crisis

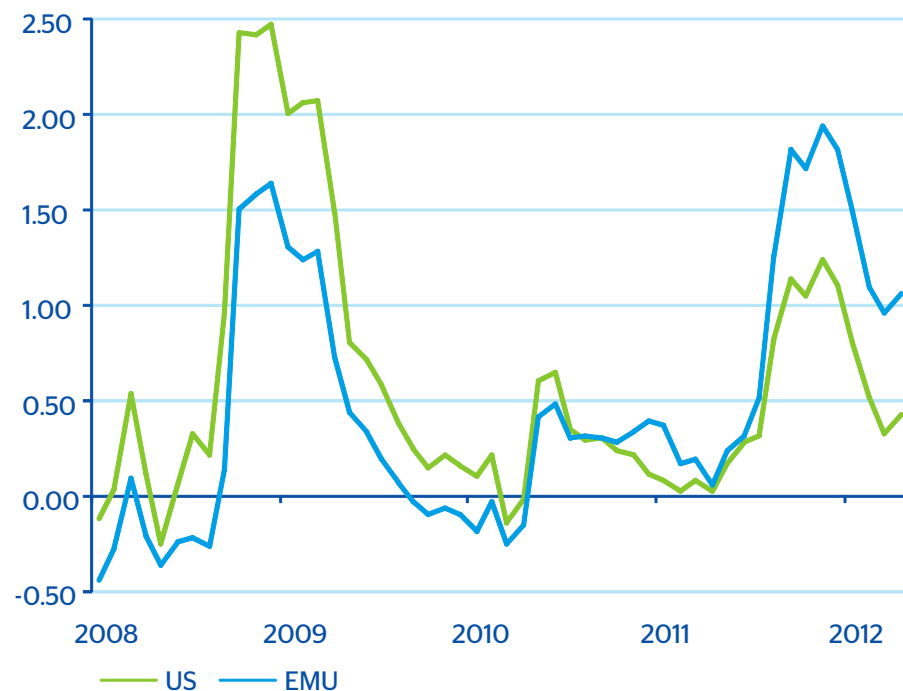
Source: BBVA Research based on Reinhart and Reinhart (2010)



Fed and BCE: At the limit of their effectiveness because of the crisis?

BBVA financial stress index

Source: BBVA Research



Central banks were successful in containing the 2008 financial shock ...

... but are now having limited success in supporting growth ...

- Decreasing returns from increasing interventions
- Increased pressure for political oversight
- Uncertain collateral damage

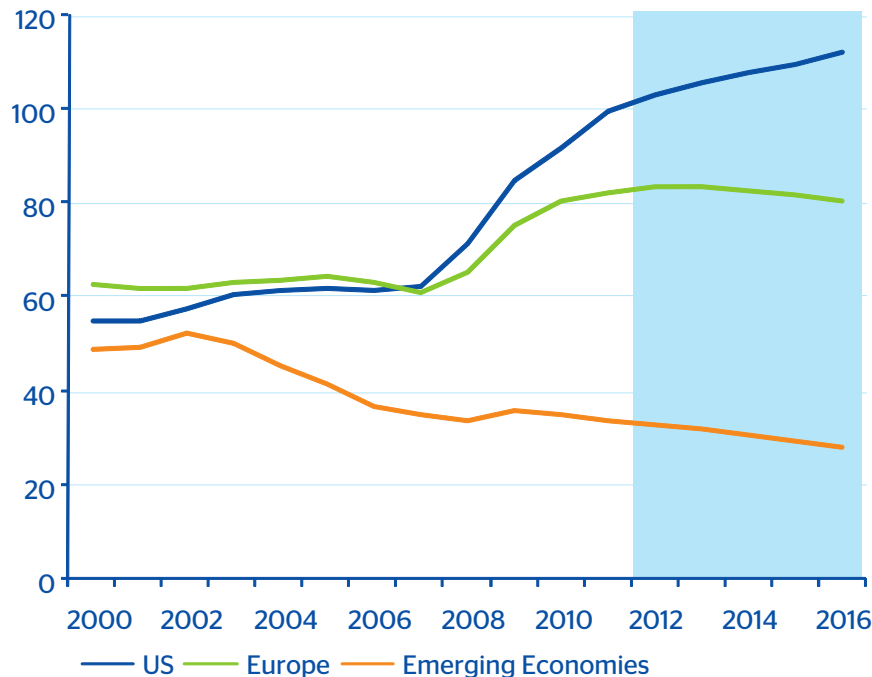
Actions are required that can only be taken by other authorities and institutions: labour market and fiscal reform, etc. There is a debate over strategy and tactics

Additionally, long-term fiscal consolidation must be addressed

Developed economies emerged from the crisis with unprecedented peacetime levels of public debt. And under pressure from ageing populations

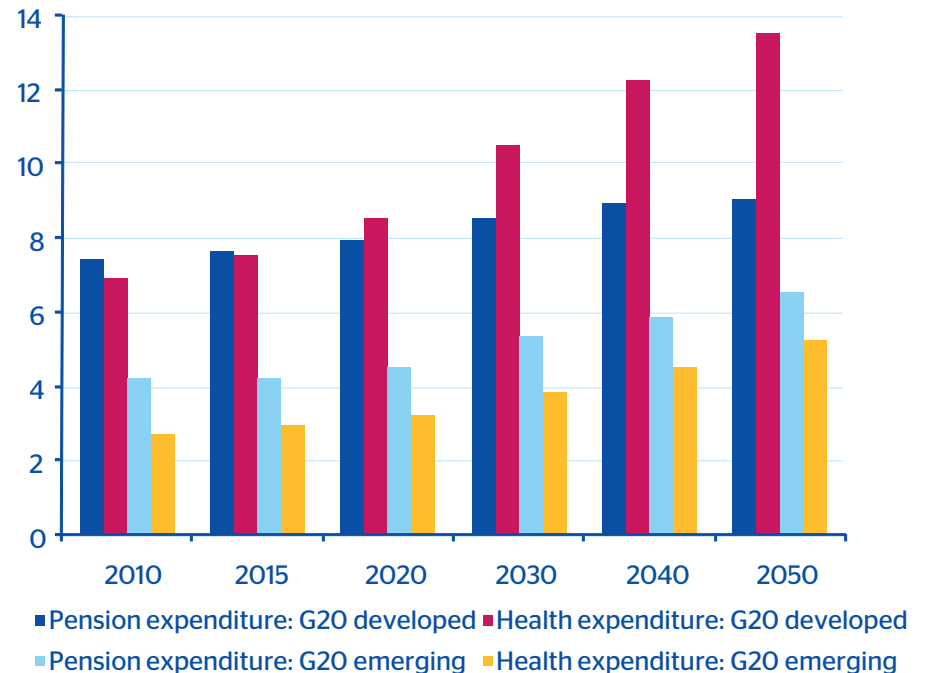
Public debt (% GDP)

Source: BBVA Research and IMF



Forecast health and social security expenditure (% GDP)

Source: BBVA Research and IMF



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What is going on in Europe? Is this an economic or a political crisis?

Two types of unknowns on the path to monetary union in the euro zone

A

Known unknowns

B

**Surprises
(unknown unknowns)**



Why aren't they taking action?

A What do some critics fear might happen in a monetary union?

Known unknowns

The euro is not an optimal monetary area (and will not become so endogenously)

A single monetary policy might be destabilising for some countries

There could be imbalances in real exchange rates for long periods

The markets will not value sovereign risk appropriately: fiscal union is needed

Difficult to honour the promise “no bail-out” a member state

Is financial integration needed: European bank resolution?

A Why aren't they taking action?

**Nominal rather than real criteria
(Maastricht)**

**Few countries are taking regional
differences seriously: flexibility,
reforms, European-level banking
supervision**

**Lack of vigilance and lack of European
policies for a single market (also
applies to international bodies)**

**“State politics” against
“insignificant details”**

Reform fatigue after entry efforts

Good times lead to self-deception

**Complacency about capacity to solve
problems as they arise**

B What was a surprise (partial or total)?

Unknown unknowns

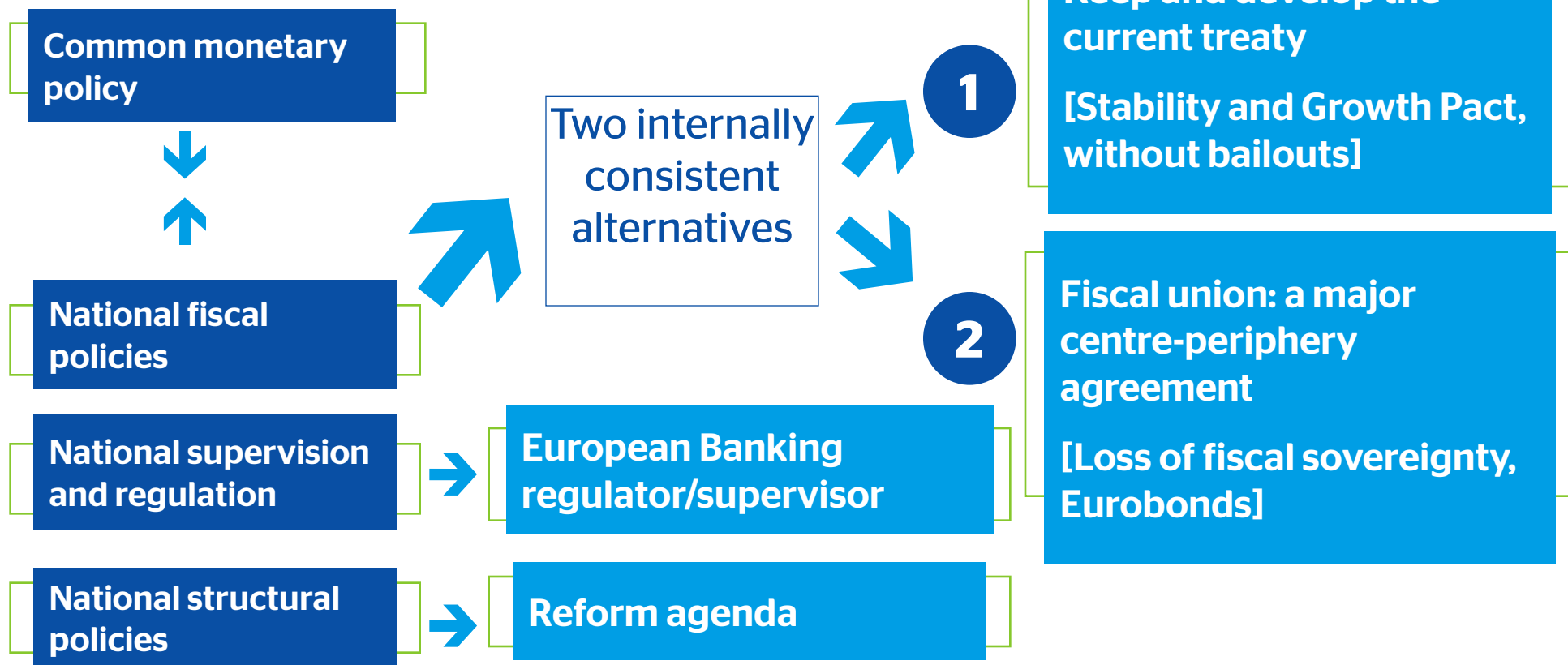
Current account deficits should not be relevant in a monetary union

High correlation between sovereign risk and banking risk

The consequences of not having a central bank as bond purchaser of last resort (issues in foreign currency?)

Two (internally consistent) routes towards a viable monetary union

An unstable mixture



Both options have challenges and risks

Options

... and risks

1

Keep and develop the current treaty

[Stability and Growth Pact, without bailouts]

- Risk of depression
- Risk of non-payment and global contagion
- Risk of social and political crisis and collapse of the euro

2

Fiscal union: a major centre-periphery agreement

[Loss of fiscal sovereignty, Eurobonds]

- Moral risk if poorly designed
- A two-speed Europe?

**Main dilemma:
Instability vs.
incentives**



The "muddling through" strategy will probably continue, with gradual progress towards a model of fiscal union

Possible structural ways out

Many potential ways out for the structural problem of the monetary union have been suggested, but these are not all compatible with the current degree of economic and political integration, which will have to change

Frequently mentioned options

Level of integration and centrality of governance

Bond purchases by the ECB (ultimate sovereign lender of last resort)

TOTAL

Mutualisation of debt (Eurobonds)

HIGH

Support mechanisms and giving time for structural reforms and fiscal adjustments

REASONABLE

The European crisis must be addressed on 3 main fronts

Dissipate concerns about sovereign solvency outside Greece and avoiding contagion to countries that are solvent but illiquid

Progress with reforms to increase growth: pace of fiscal adjustment and policies to stimulate growth

Make changes to the governance of the euro to design a roadmap towards fiscal union and a single bank resolution fund

Some progress so far, but more needed

Timid advances, but there are important pending issues

Some progress...

... but some issues still pending

1

Implementation of the Greek debt haircut

A credible sovereign firewall

2

Approval of the fiscal compact

Further advances towards fiscal union and slowing its application

3

Provision of ECB long-term liquidity

A pro-growth agenda



Measures taken so far have only enabled us to muddle through the crisis
The authorities remain behind events

1 Greece: concerns linger about solvency. Attention on Portugal

Greece

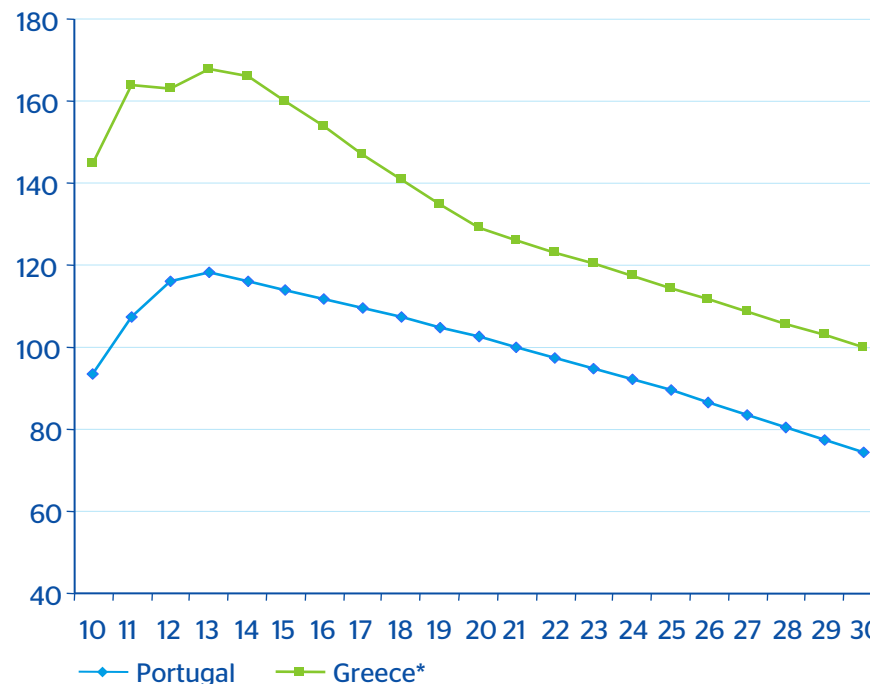
- Risks remain:
 - The 6 May elections
 - A long hard slog for further reforms
 - Recession to continue

Portugal

- Fiscal adjustments and reforms are on track
- External imbalance closing
- But this will not be sufficient to access markets in Q3 2013

Greece and Portugal: public debt projections

Source: BBVA Research and IMF



* Optimistic scenario for Greece. Assumes 95% bond holder participation in haircut; growth of around 3% from 2015; and a primary surplus of 4.5% of GDP from 2014 (primary deficit 2.4% in 2011)

1 The sovereign firewall (EFSF/ESM) is not enough to reassure markets

(ESM)

New available lending capacity: EUR 500 Bn (more than 200 Bn already committed by EFSF), and a further 420 Bn from the IMF

But...

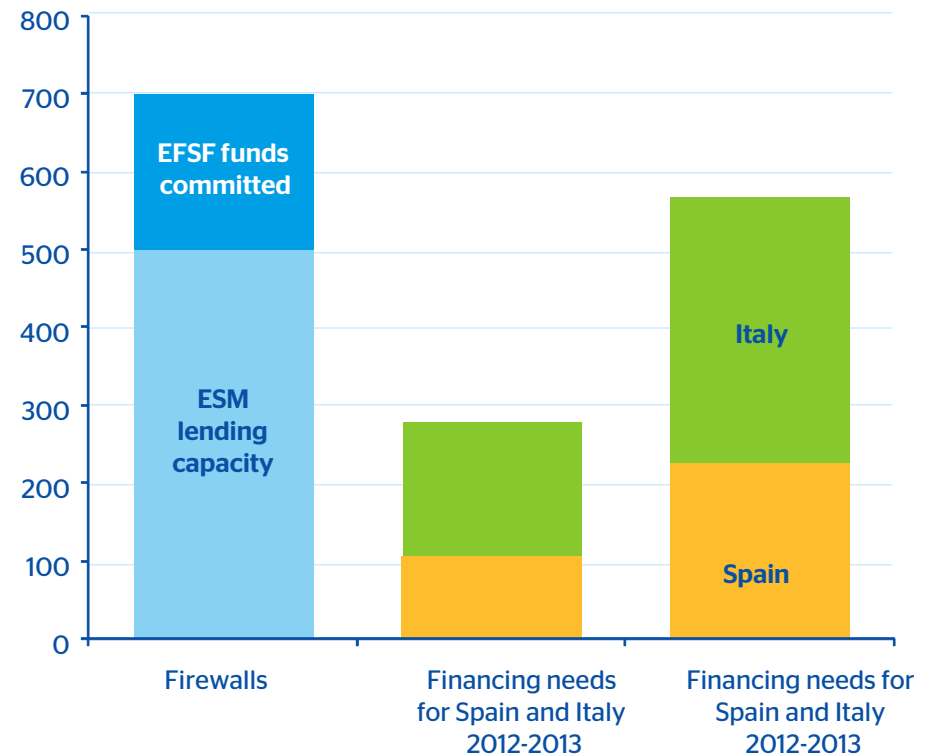
It is not enough to reassure markets, given financing needs in Spain and Italy

It cannot intervene directly in financial systems

Unless it lends *pari passu* it risks alienating private demand for sovereign bonds

ESM/EFSF resources and gross financial needs in Spain and Italy (long-term debt and deficit)

Source: BBVA Research and Bloomberg



2 Fiscal compact is sanctioned, but may be seen as too lax

- The fiscal compact commits governments to establish a fiscal rule at constitutional level, limiting structural budget deficits to 0.5% of GDP
- Still no progress on fiscal union, or on short-term fiscal adjustment

Fiscal compact

A significant change towards fiscal control of member states

May be seen as not strong enough to justify a more forceful and decisive action by the ECB or German hardliners

Still pending: a roadmap to a fiscal union

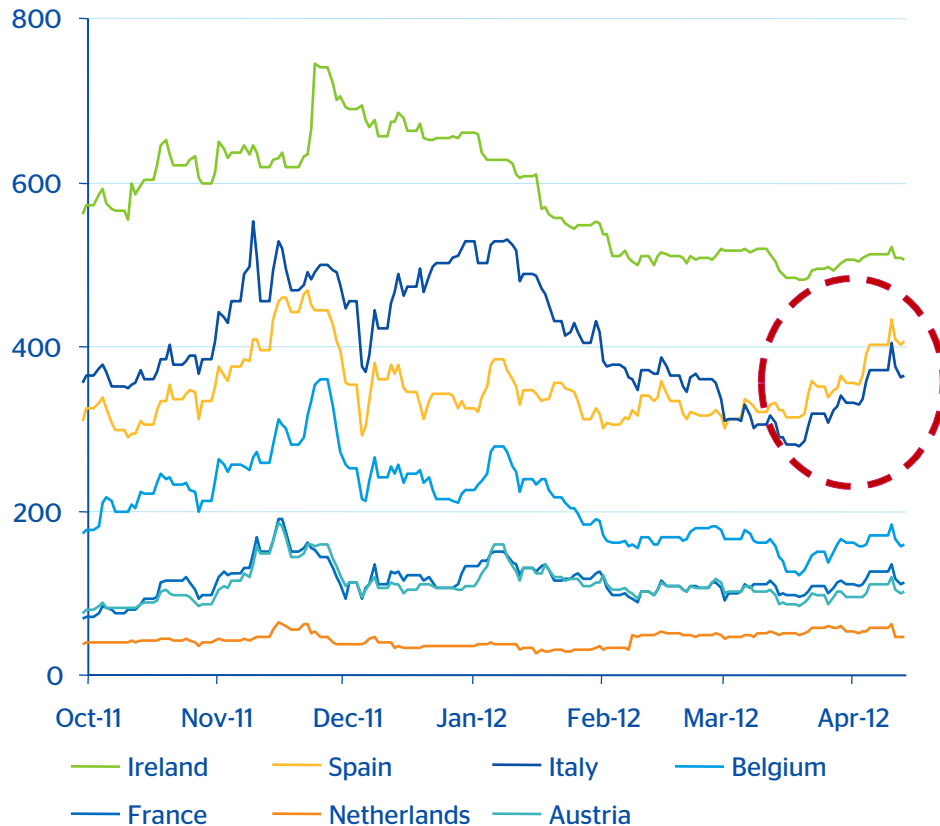
Eurobonds: convenient as an insurance mechanism and roadmap

Proposal of “blue” and “red” bonds has the advantage of maintaining market discipline

3 Provision of long-term liquidity by the ECB calmed markets temporarily, with some unease...

Sovereign spread vs. Germany (10 year bond, bps)

Source: Bloomberg and BBVA Research



Liquidity risk on European banks eased during the first quarter...

... and funding markets were opening up cautiously, helping to reduce sovereign spreads

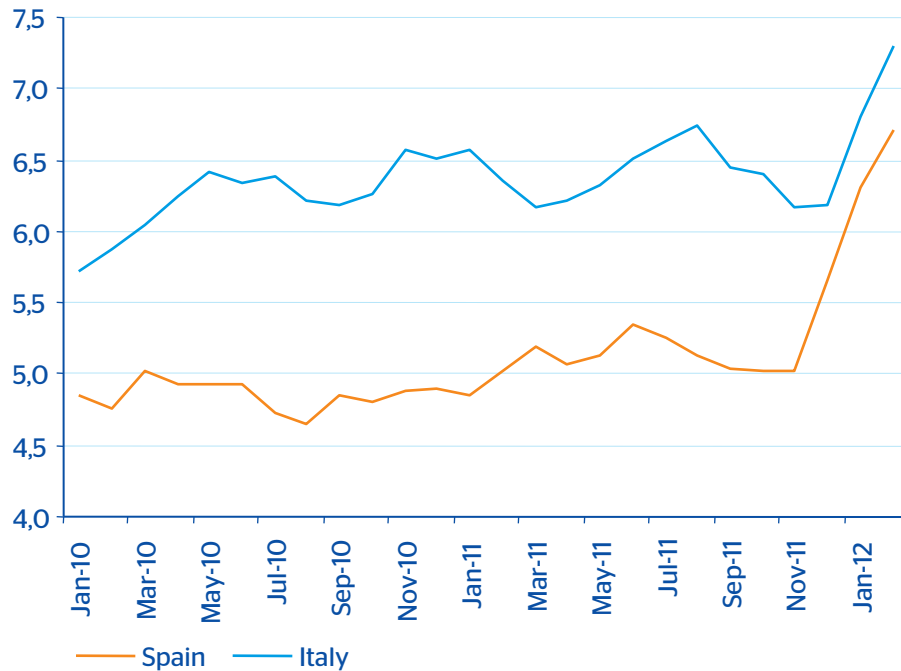
but these effects have been short-lived. Recent doubts on Spain have increased tensions

In any case, the ECB can only serve as a bridge to the long run, which depends on structural reforms and a growth agenda

3 ... but it has also increased the exposure of banks to the sovereign

Holdings of euro area government bonds over total assets (%)

Source: ECB and BBVA Research



Indirect ECB intervention in the sovereign bond market through banks

Increased exposure of banks to the sovereign increases potential negative feedback effects

Reinforces the need for a definitive solution to sovereign solvency doubts and to the provision of liquidity

3 The reforms presented must be implemented and deepened

Italy

(technocratic government)

- Fiscal compact and consolidation
- Reform of pensions and professions
- Labour market reforms being prepared

Submitted

Spain

(Government with absolute majority for next 4 years)

- Fiscal consolidation, constitutional rule
- Restructuring of financial system underway
- Labour market reform

Submitted

Portugal

(Government with simple majority for next 3.5 years)

- Fiscal consolidation without accounting adjustments
- Deep labour market reform
- Reform of product markets underway

Submitted

Greece

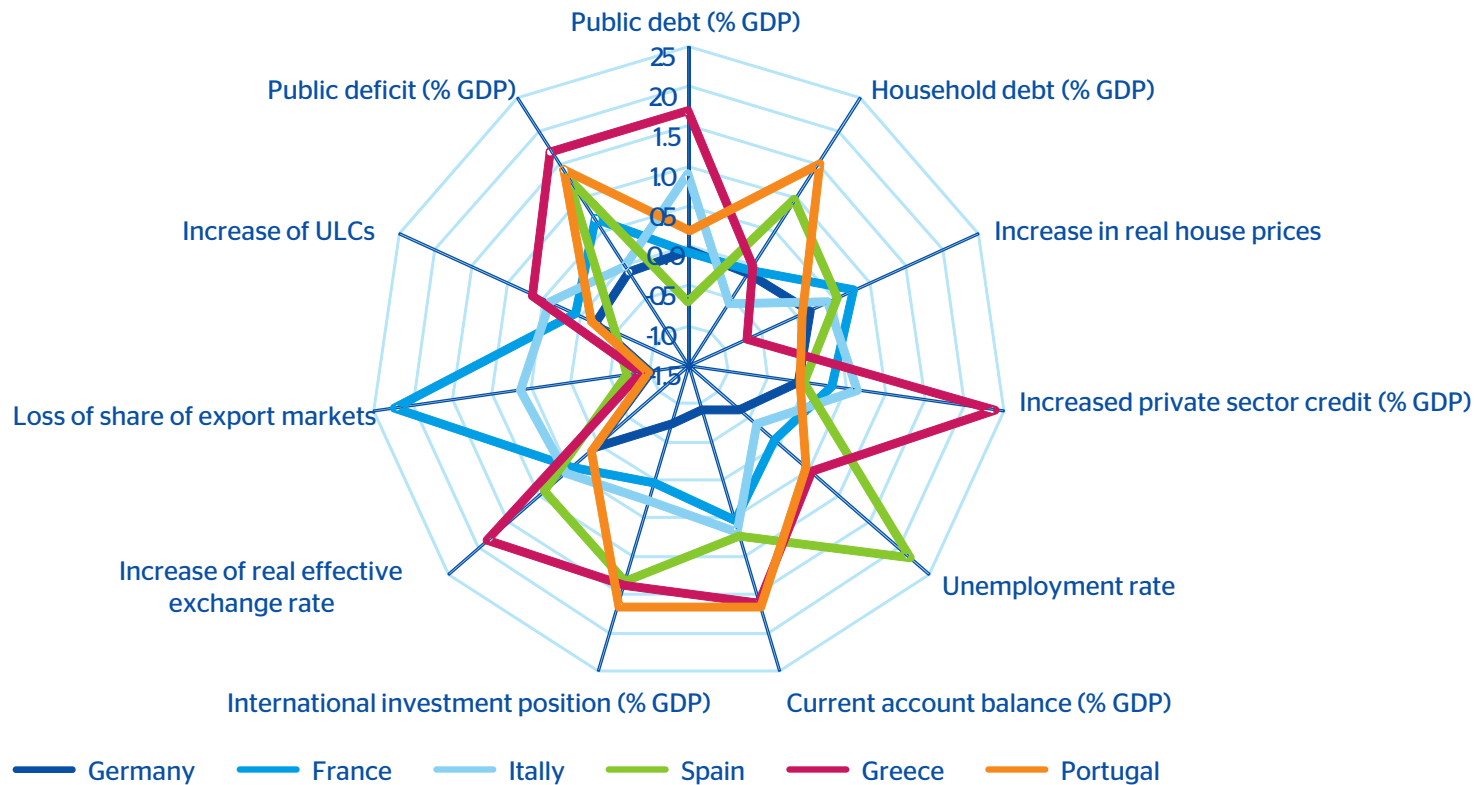
(technocratic government)

- Major challenges for fiscal consolidation
- Privatisations (?)
- Reforms to restart long-term growth

Submitted

3 Monitoring of structural imbalances in Europe (“six pack”).

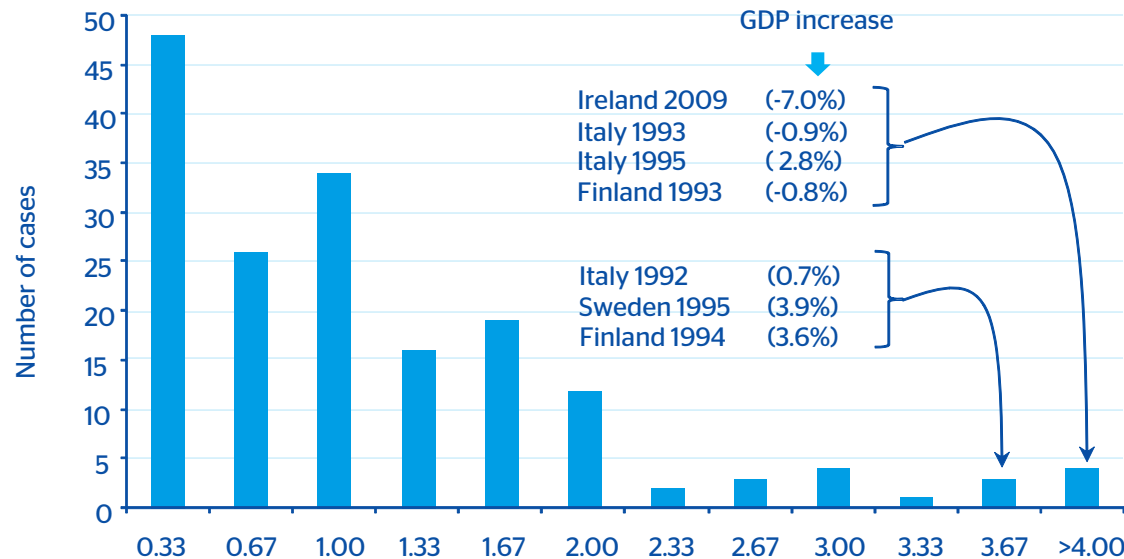
Macroeconomic imbalances in Europe's periphery (six pack) Index. Standard deviations from the euro zone average (euro zone average = 0)
 Source: BBVA Research, Eurostat and Haver



3 Very rapid correction of imbalances might be counterproductive: the fiscal example

Breakdown of fiscal consolidations in OECD countries with deficit reduction targets

Source: BBVA Research based on Devries et al (2011)



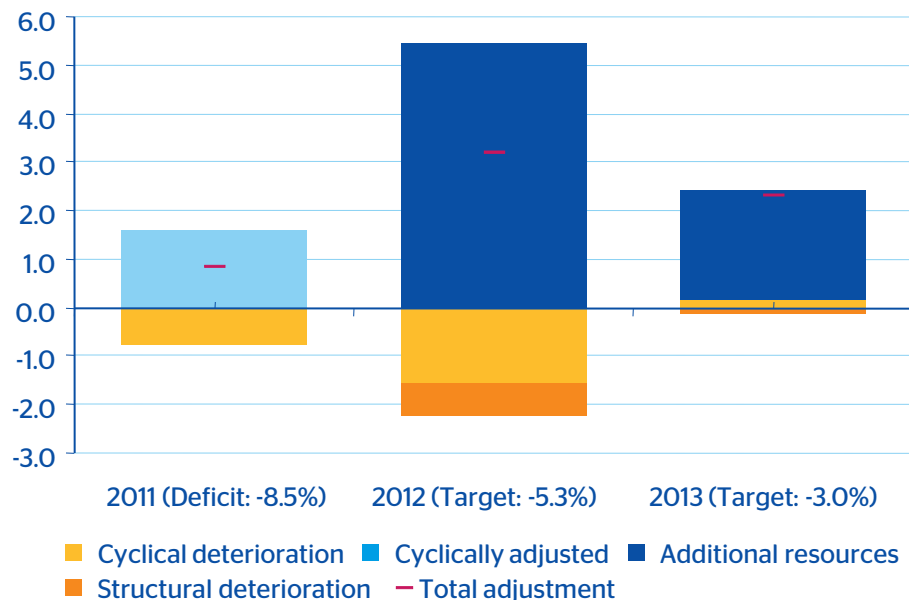
Few deficit reductions have exceeded 3% of GDP in one year

Based on 173 examples of fiscal consolidation between 1978 and 2009 involving 17 OECD countries (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Holland, Portugal, Spain, Sweden, the UK and the USA)

3 Spain: the fiscal adjustment should focus on the structural component

General government: deficit adjustment (pp of GDP)

Source: BBVA Research based on MINHAP



Fiscal consolidation process

Major deviation from 2011 deficit target and unilateral decision to increase the 2012 target

Budget Stability Law: structural deficit of 0% of GDP in 2020

The central government adjustment is credible: more doubts about regional governments

Increasing fears about lack of growth

A new compact is required

The European crisis is the main risk to the global economy

Crisis

The tensions have returned quickly after: (i) the ECB's injection of long-term liquidity; (ii) structural reforms in Spain and Italy, and (iii) advances in the fiscal compact and the ESM

Why?

Investors anticipate the negative impact on growth of fiscal austerity; still see the possibility of a restructuring; and see any ESM intervention as being a trap

Roadmap to fiscal integration

Fiscal consolidation needs to be gradual and multiyear. It should focus on structural deficits.

We should not rely only on austerity measures. But rather on structural reforms in exchange for a growth strategy: symmetrical incentives are needed

Re-launch European investment in infrastructure

Solution:
eliminate the
euro area exit
scenario

... the political factor is becoming every more important (*déjà vu* Latam?)

EMBI Latam spread in electoral periods

Source: BBVA Research and JPMorgan



European event calendar. April-July 2012

Source: BBVA Research

Apr 22: French presidential elections (1 st round)
May 6: Greek legislative elections
May 6: French presidential elections (2 nd round)
May 6: German state election (Schleswig-Holstein)
May 13: German state election (North Rhine-Westphalia)
May 31: Irish referendum (fiscal compact)
End May: Troika fourth review of Portugal's package
Jun 10,17: French legislative elections
Jun 18-19: G20 summit.
Jun 27: Possible date of general election in Holland
Jun 30: Deadline to reach 9% core tier 1 capital ratio
July: ESM enters into force
Summer: Negotiations for second Portuguese bailout programme

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For example, progress has been made in Spain on pension reform

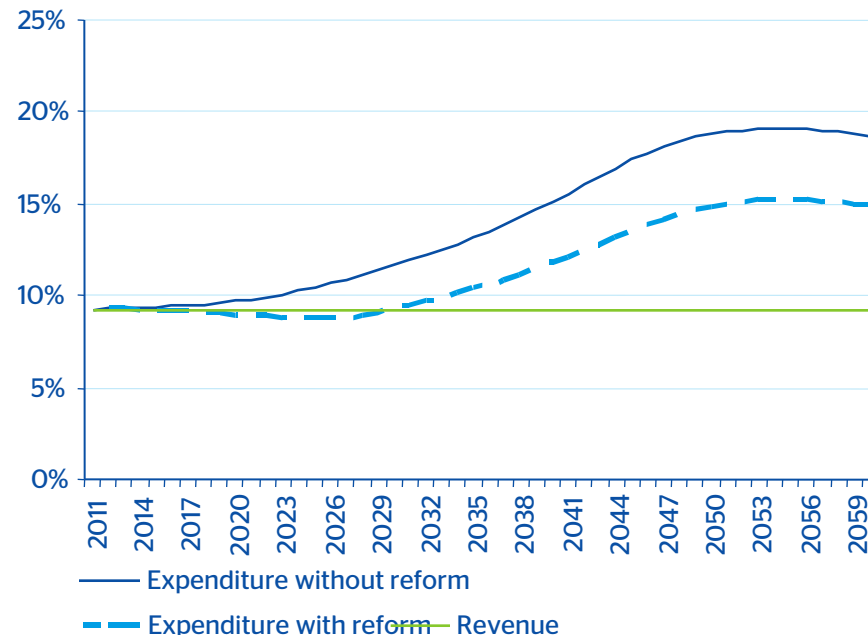
- Reform of the pension system will help to improve the outlook for sustainability of the system by reducing pension expenditure as a share of GDP
- This is a substantial reform, making significant changes to the system

Sustainability factor

- Given uncertainties about employment, productivity and demographics, it is appropriate for the reform to be assessed from the moment that it is implemented
- If necessary, the sustainability factor will have to be applied prior to 2027

Contributory pension expense as % of GDP. Post-reform simulations

Source: BBVA Research



Contributory pensions system Spain vs. Germany

There are notable similarities in the reforms of the Spanish and German public pension systems. However, the Spanish system continues to be more generous

	Spain	Germany
Official retirement age	67	67
Number of years' contributions at official age to get 100% base pension	38.5	45
Rate of public pension substitution before reforms	81.2%	48%
Early retirement age	61/63	63
Number of years' contributions for early retirement	33	35
Rate of public pension substitution after reforms	69% (e)	43%
Correction for sustainability factor	From 2027	YES
Years' credit for dependent children	2	3
Third-pillar coverage of population	7%	64%

3 Major deficit reductions have involved significant tax increases

Larger fiscal consolidations in the OECD, 1978-2009: breakdown by adjustment type

Source: BBVA Research based on Devries et al (2011)

In cases of large deficit reductions, spending was not trimmed by more than 2.5 pp of GDP (except in cases of high initial tax burden)

