

Europe Outlook

February 2015



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World economy: where are we heading to?

What happened as of late?

GDP has grown faster than in the first half of 2014, but with major differences between countries

Low **inflation** is generalized, driven by falling oil prices

Change in **oil** price is a big positive shock

Financial tensions increase but with a significant heterogeneity

Growing concern about the economic impact of **geopolitical events** (Russia, Middle East)

What do we expect in 2015-16?

Stronger global **growth** driven by oil, but with large differences by area

Lower **inflation** in all areas, reaching too low levels in some areas

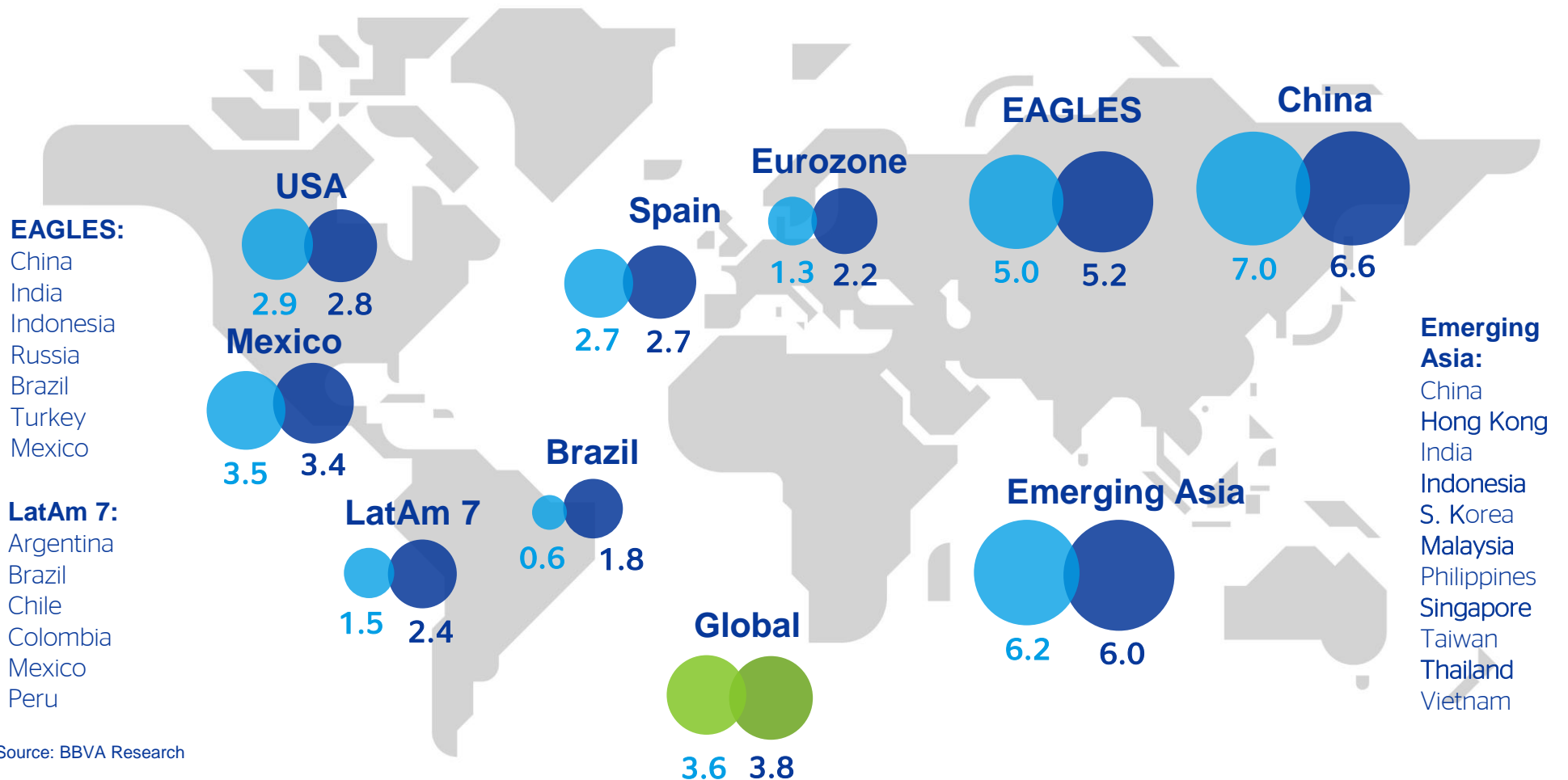
Divergence in **monetary policies**: relaxation in Europe, China and Japan, and gradual tightening in the US

Markets differ depending on the exposure to global shocks and the fundamentals of each country

Politics into the spotlight in 2015, especially in Europe

World growth: moderate and uneven acceleration

● 2015 ● 2016



Risks are still tilted to the downside



Developed countries
Indebtedness

Europe

- Stagnation
- Lack of consensus on reforms
- Greece
- Russia-Ukraine

China
Hard landing

Global
Destabilisation of some countries as a result of low oil prices

EMs
Response to the Fed's rate hikes

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What's new in Europe?

1) Oil price shock is positive as it is mostly supply-driven

2) Monetary policy: large and open-ended QE programme

3) Exchange rate: Euro depreciation will boost exports

4) Juncker's Plan: sizeable impact if well implemented

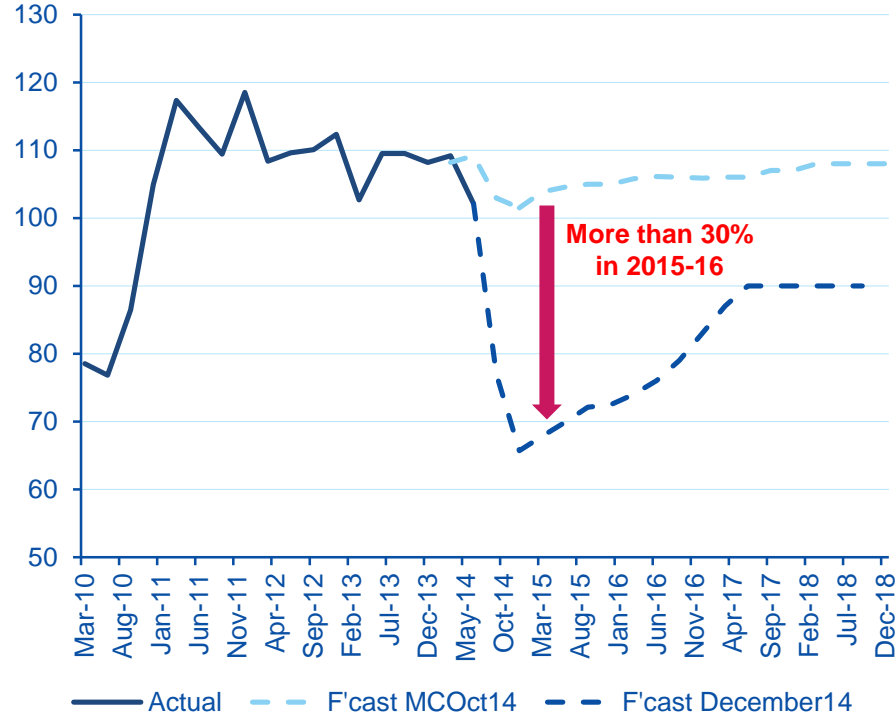
5) Neutral fiscal policy

6) External environment: Slowdown in Russia and China

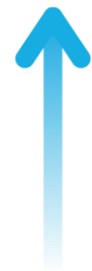
1) The fall in oil prices is positive for growth

Oil price (Brent, USD/b)

Source: BBVA Research



- The reduction in the cost of crude will boost eurozone GDP growth in 2015 and 2016



0.2-0.4%

2) ECB's response to deflation risks: a wider-than-expected QE

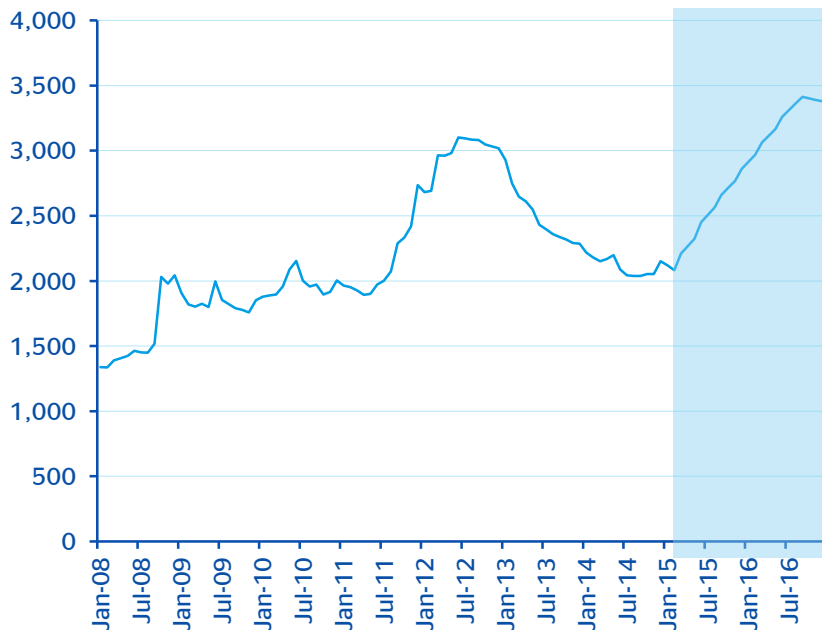
Decision	On January 22 the ECB finally announced an extended asset purchase programme, including public and private securities (QE)
Format	Open-ended: monthly purchases of €60 bn of public and private debt since March 2015 until September 2016 or until inflation follows a proper path
Amount	Overall, the program could exceed €1,100 bn of public and private debt (of which around €800 bn could be sovereign bonds) and ECB's balance sheet will reach € 3.3 bn in Dec 2016
Further details	<ul style="list-style-type: none">• Maturities longer than expected: 2-30 years• Pari-passu• Purchases according to capital key• Some limits: 33% of issuer's exposure and 25% of each issue

However, risk sharing of sovereign bond purchases will be very limited (8%)

3) ECB's QE has led to euro depreciation

ECB balance sheet and projections (€bn)

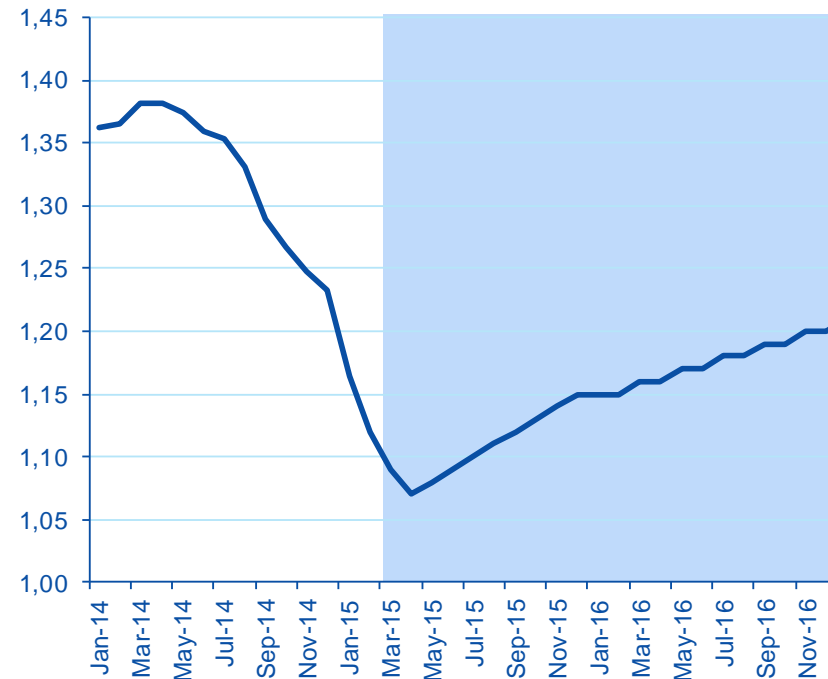
Source BBVA Research and Bloomberg



The ECB's balance sheet will expand by at least EUR1,100 Bn

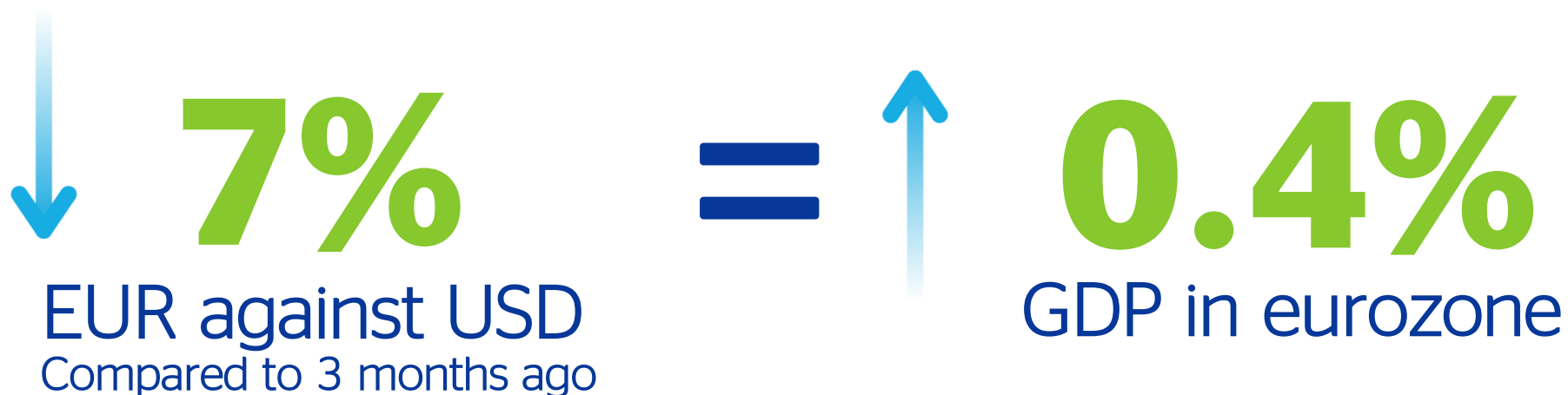
EURUSD exchange rate (%)

Source BBVA Research and Bloomberg



Euro will be 7% more depreciated than expected in 2015

3) ECB's QE has led to euro depreciation



USD/EUR 1.1
2015 average

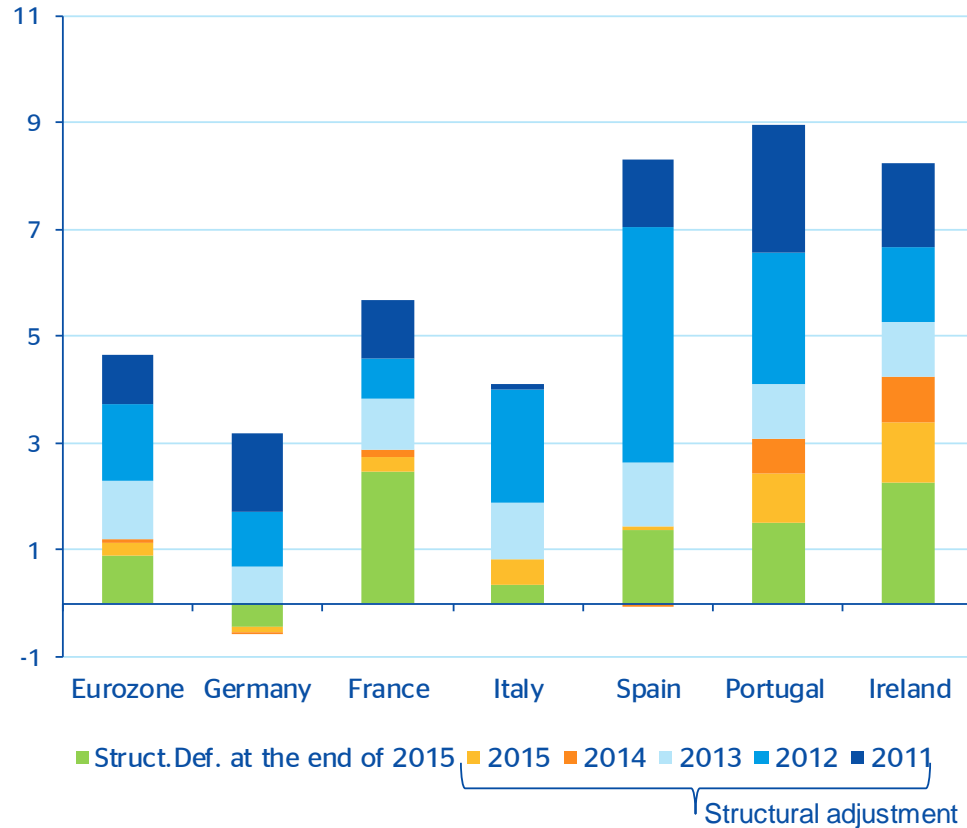
4) Juncker's Plan: Impact of up to 0.5% per year in 2015-17 if successful

	Main features	Evaluation
Institutions	European Fund for Strategic Investment (EFSI): EC, EIB & countries	
	Majority control by EC	Positive as EIB is too conservative choosing projects
	Voluntary additional contributions by countries not computed as deficit	Possible way to stimulate fiscal policy through the back door
Quantities, sectors	Guarantees, no new debt	No "fresh money", no fiscal stimulus
	Leverage 1/15: EUR21bn onto EUR315 bn Starting mid-2015 3 years	Likely leverage as liquidity is high, in line with other EIB projects
	Infrastructure projects (EUR240bn) SMEs (EUR75 bn)	Key is first loss by EFSI Need to focus on risky projects to maximize net investment

5) Fiscal policy more favourable than in previous years

Structural deficit adjustment 2010-2015 (% GDP)

Source: BBVA Research and IMF



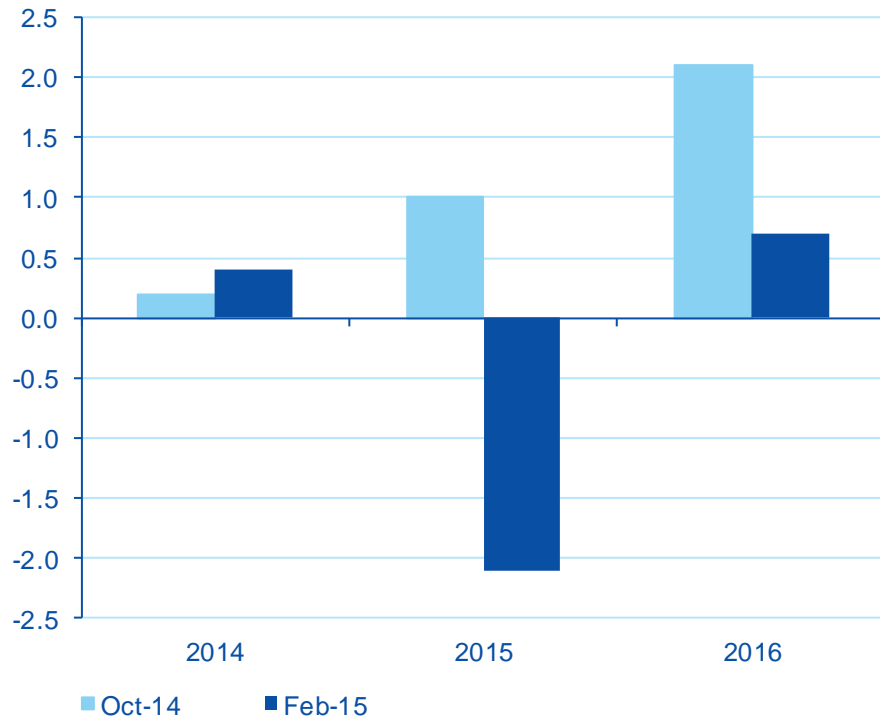
Small consolidation required in 2014 and 2015 as compared to previous years

European Commission more careful not to force pro-cyclical adjustments

6) Russia: Impact through trade channel, but also on confidence and investment

Russia: annual GDP growth forecast revision (%)

Source: FocusEconomics



Russia: Large downward revision in GDP forecast

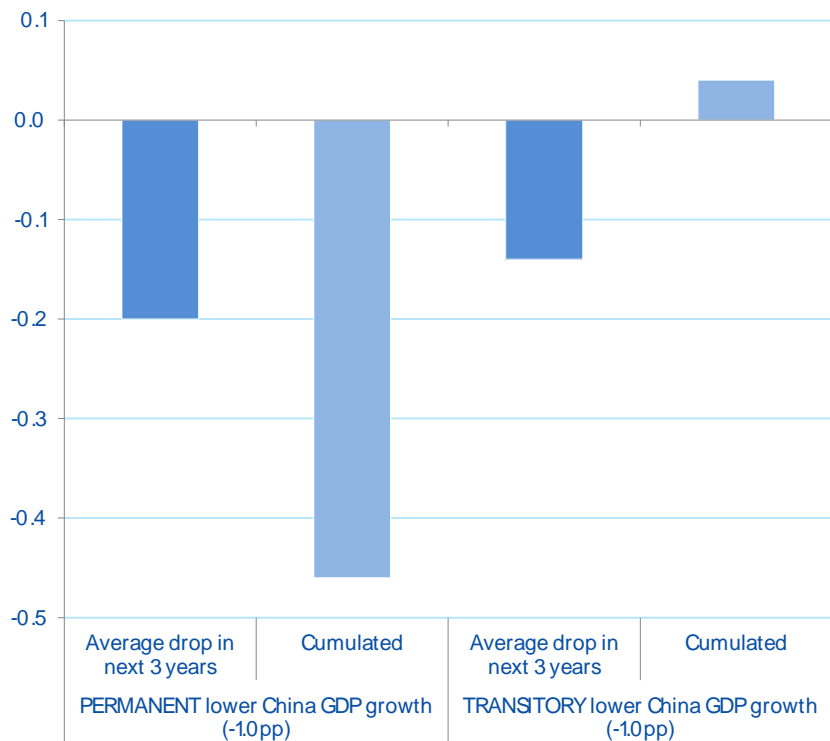
Impact through trade channel (bilateral) seems to be limited...

...but total effect (via other trading partners, financial channels...) could be up to -0.6pp

6) China: downward revision of growth in 2016 (-0.4pp)

Impact of lower growth in China on EMU GDP growth (pp)

Source: BBVA Research



China: Oil price fall increases the room to manoeuvre to ensure a soft landing...

...without too much policy stimulus needed, which would increase risks (financial fragilities and the real estate adjustment)

Limited impact on the eurozone (around -0.1pp). But foreign demand remains key to underpin investment recovery

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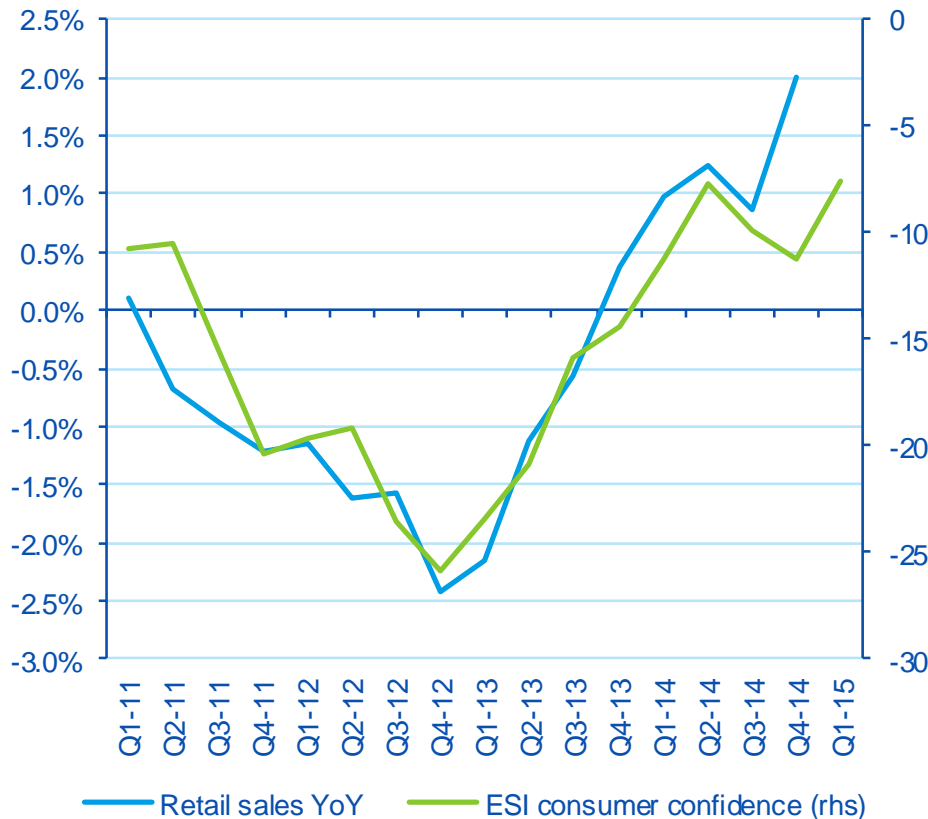
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Confidence recovery is finally supporting domestic demand, especially consumption

Consumer confidence and retail sales

Source: Eurostat, EC and BBVA Research



Significant fall in confidence over the summer across countries and sectors, but recovering at the beginning of Q1

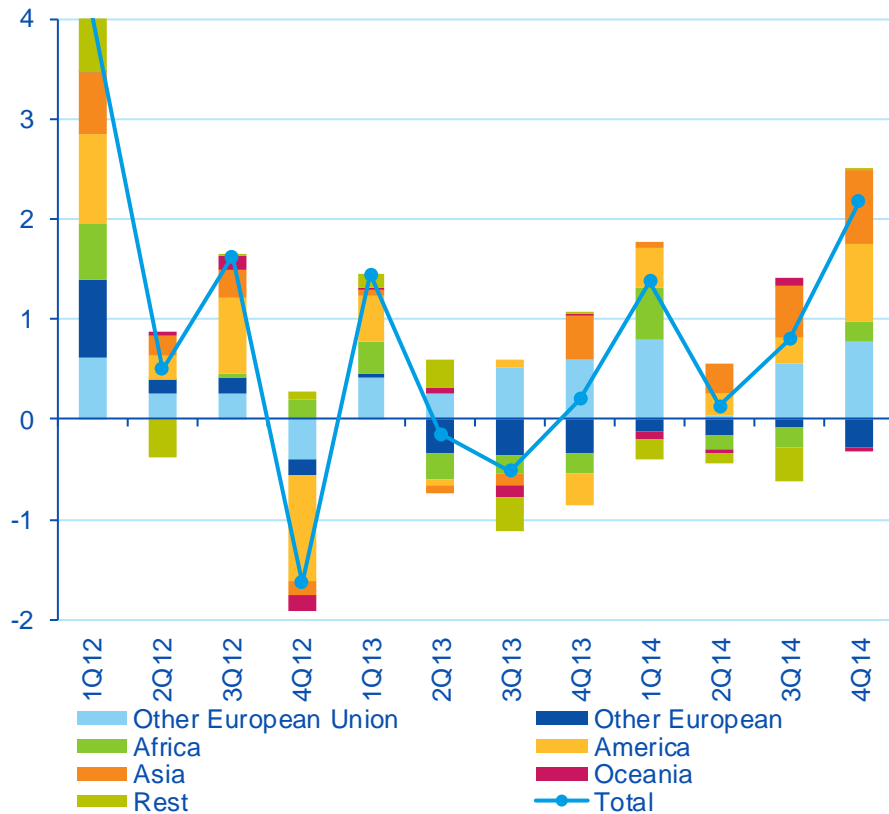
Improving hard data

The eurozone's economy grew at an annualised rate of just over 1% in 4Q14

Exports are recovering supported by a lower euro and stronger demand from advanced economies

UEM: Exports by destination (%QoQ)

Source: BBVA Research



The depreciation of the euro has boosted eurozone exports...

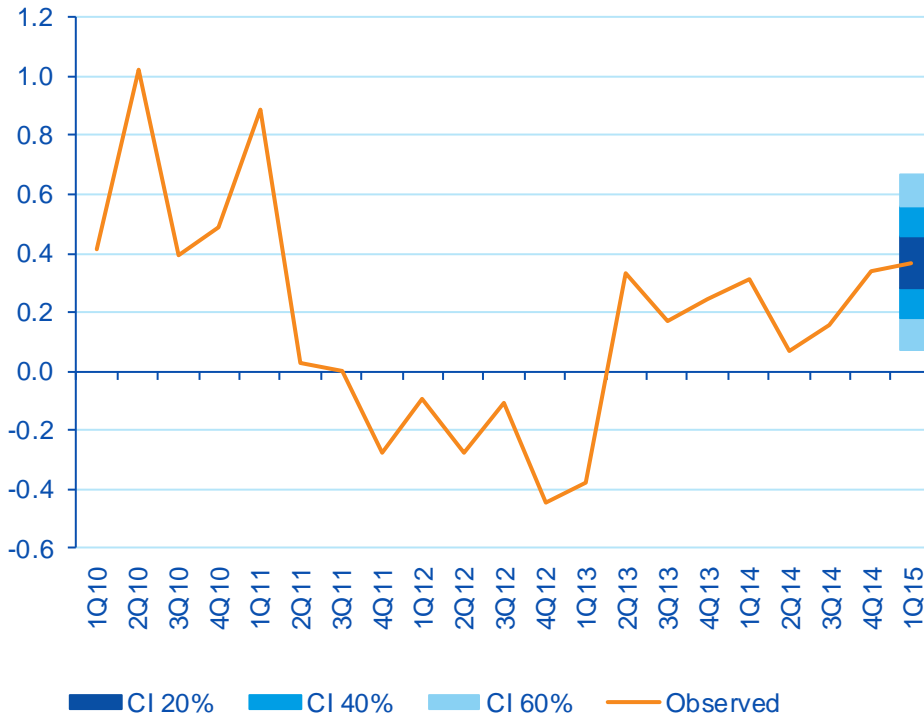
... which have been accelerating by the end of 2014...

...especially those bound for the US and the rest of Europe

The recovery is evolving as expected, with more growth in Germany and Spain than France or Italy

MICA-BBVA GDP short term model (% QoQ)

Sources: Haver and BBVA Research

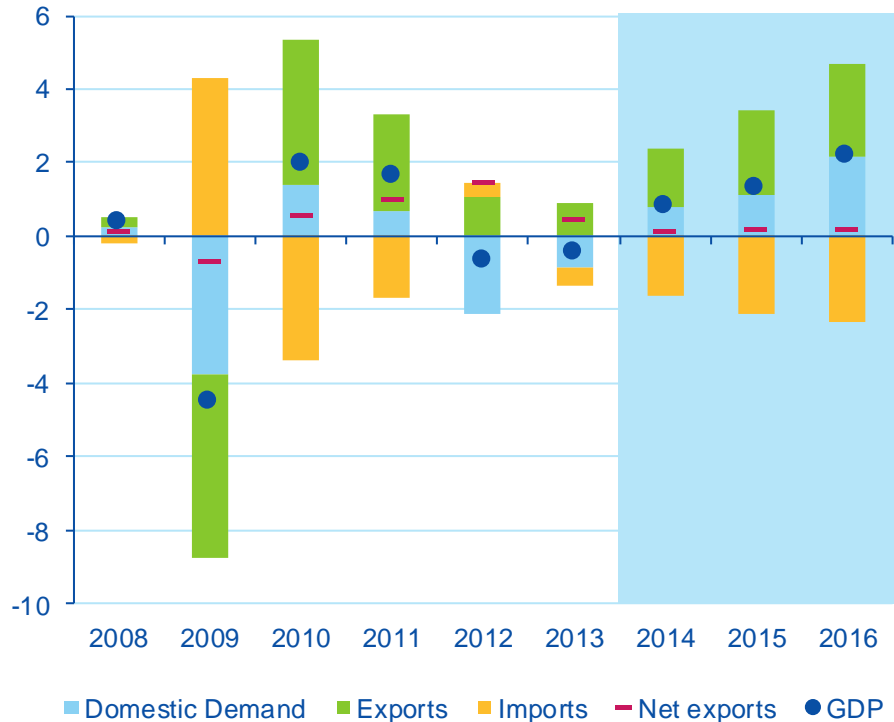


GDP growth (QoQ)	2Q14	3Q14	4Q14	1Q15 (f)
Eurozone	0,1%	0,2%	0,3%	0,3%
Germany	-0,1%	0,1%	0,7%	0,5%
France	-0,1%	0,3%	0,1%	0,3%
Italy	-0,2%	-0,1%	0,0%	0,3%
Spain	0,5%	0,5%	0,7%	0,9%
Portugal	0,3%	0,3%	0,5%	0,4%

Forecast: growth will be between 1% and 1.5% in 2015

EMU: annual GDP growth contributions (pp)

Sources: Eurostat and BBVA Research



	2013	2014 (f)	2015 (f)	2016 (f)
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Activity

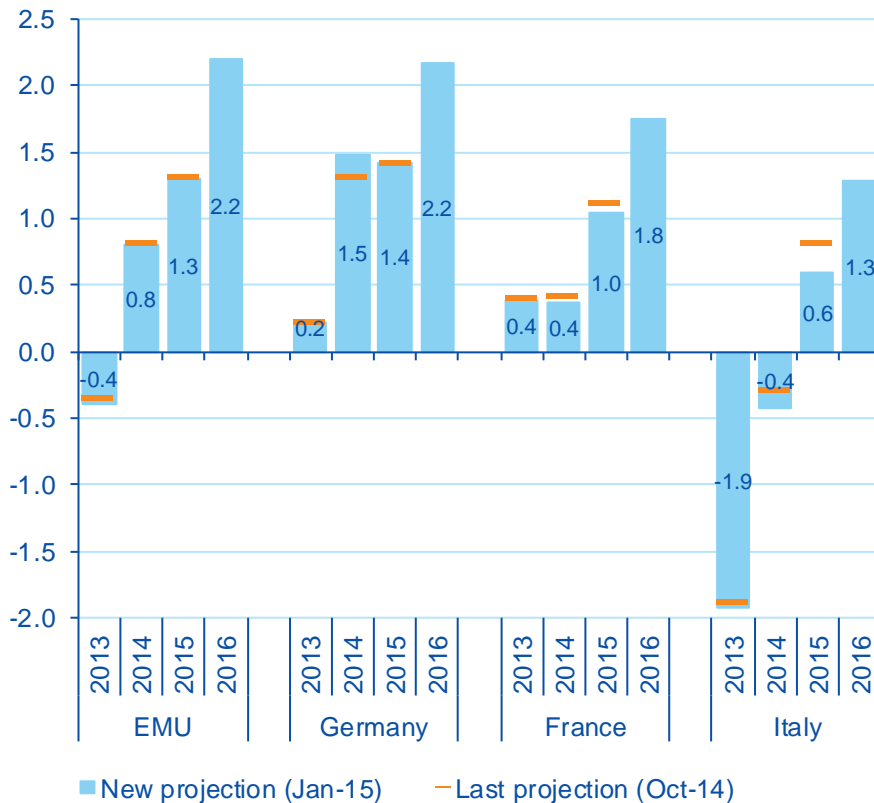
REAL GDP (% YoY)	-0,4	0,8	1,3	2,2
Private consumption	-0,6	0,9	1,4	1,7
Public consumption	0,2	0,9	0,5	0,9
Investment	-2,4	0,7	0,9	4,6
Domestic demand (contr. %)	-0,9	0,7	1,1	2,0
Exports	2,1	3,7	4,8	4,9
Imports	1,2	3,7	4,8	5,0
Net exports (contr. %)	0,4	0,2	0,2	0,1

Current account balance(% GDP)	2,4	2,5	2,7	2,7
Public deficit (% GDP)	-2,9	-2,7	-2,5	-2,0
CPI, % average	1,4	0,4	0,1	1,0

Across countries, Germany will continue to lead France and Italy

GDP forecast by country (%)

Sources: Eurostat and BBVA Research



- Germany: growth will continue to be driven by domestic demand

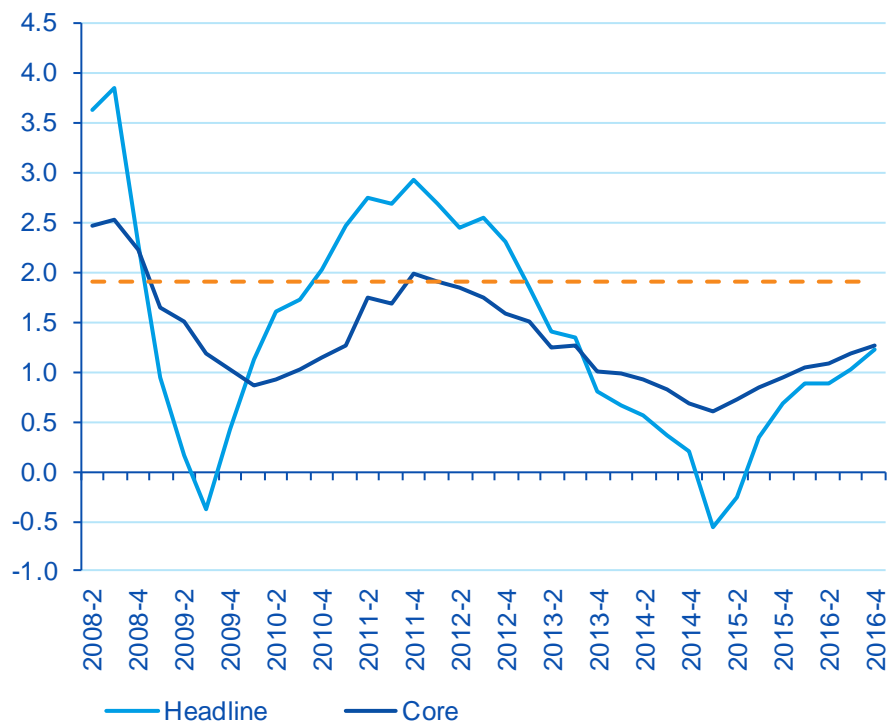
- France: the pace of recovery depends on continued structural reforms and reinforcing competitiveness

- Italy: Finally out of recession in 2015, though the recovery is slow
- Exports will be the main driver of growth

Headline inflation: significant downward revision driven by the fall in oil prices

Headline and core inflation (% YoY)

Source: BBVA Research



The impact of a 10% shock in oil prices is 0.2%/0.3% lower inflation, and less than 0.1% in core inflation

Negative inflation expected over the first half of 2015, and core inflation is still very low (below 1%)

The recovery in 2015, the end of falling oil prices and the ECB's QE will help to redress inflation expectations in the medium term

Europe faces important challenges and risks

Short term

Geopolitical risks

Several elections in 2015-16, risk of populism

Risk of stagnation and deflation

Medium and long term

Low potential growth

Further fiscal and economic integration

Lack of consensus on reforms

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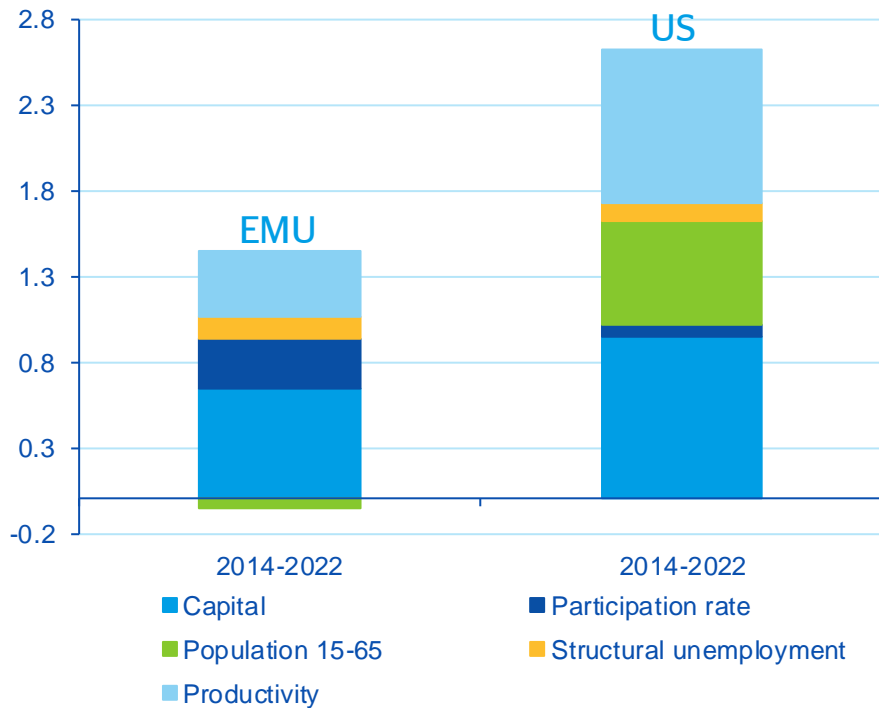
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Low potential growth in the EZ vs the US

US and EZ projected potential GDP growth (pp)

Sources: Eurostat and BBVA Research



Lower potential well below that in the US

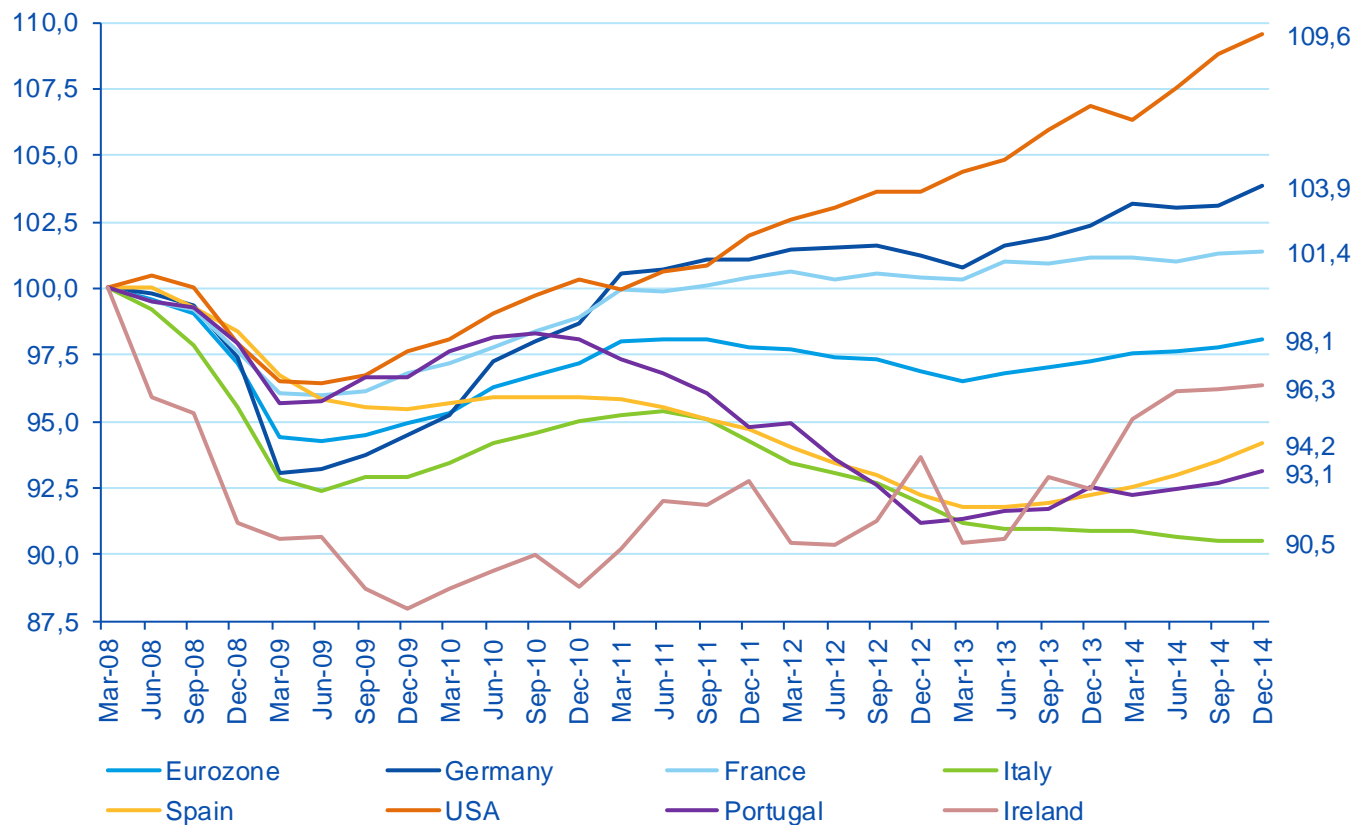
Slower population dynamics and productivity growth are the main reasons of the gap

Where do we stand after the crisis?

GDP

Note: Q1-2008=100

Sources: Eurostat, Haver and BBVA Research



Heat map of macroeconomic imbalances

	Public Debt	Public Deficit*	Unemployment Rate	Current Account	Net International Investment Position	Real Effective Exchange Rate	Nominal Unit Labour Cost	Household Debt	Non-Financial Corporations Debt
	% of GDP	% of GDP		% of GDP	% of GDP	3-yr % chg.	3-yr % chg.	% of GDP	% of GDP
	Q4-2013	2013	Latest	2013	Q4-2013**	Sep. 2013	Latest	Latest	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

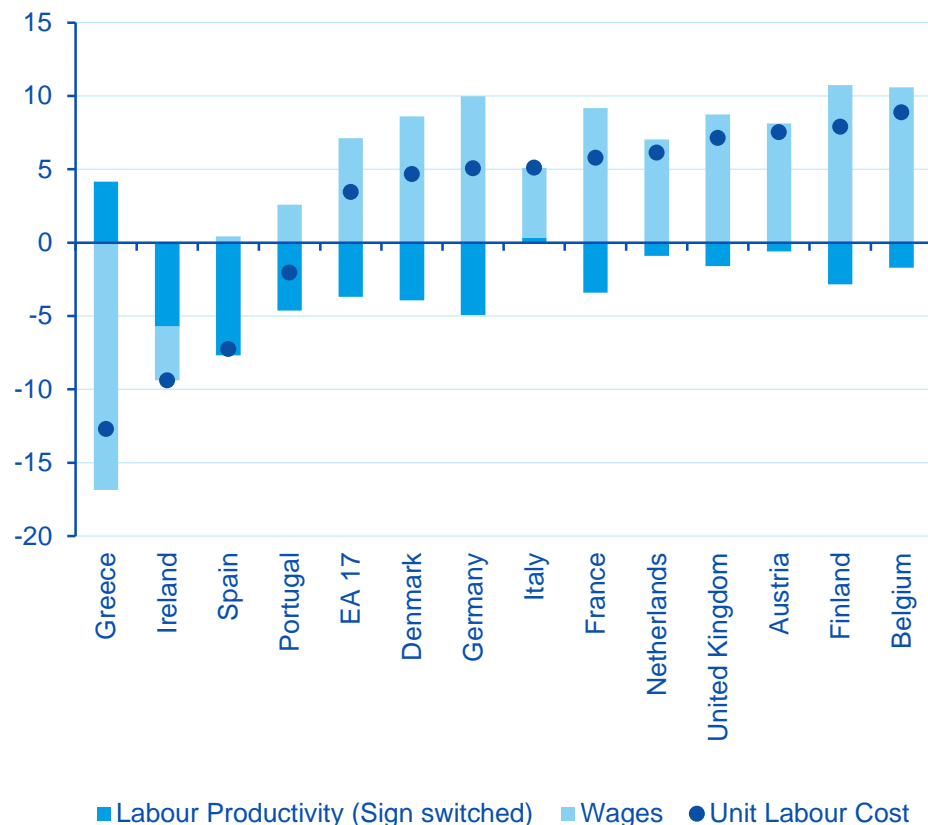
**Data for France: 4Q-2012

Source: Eurostat, BCE, Haver and BBVA Research

Unit labor costs have adjusted in the periphery

Unit labour costs adjustment, 2009-2013 (%)

Sources: Haver y 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

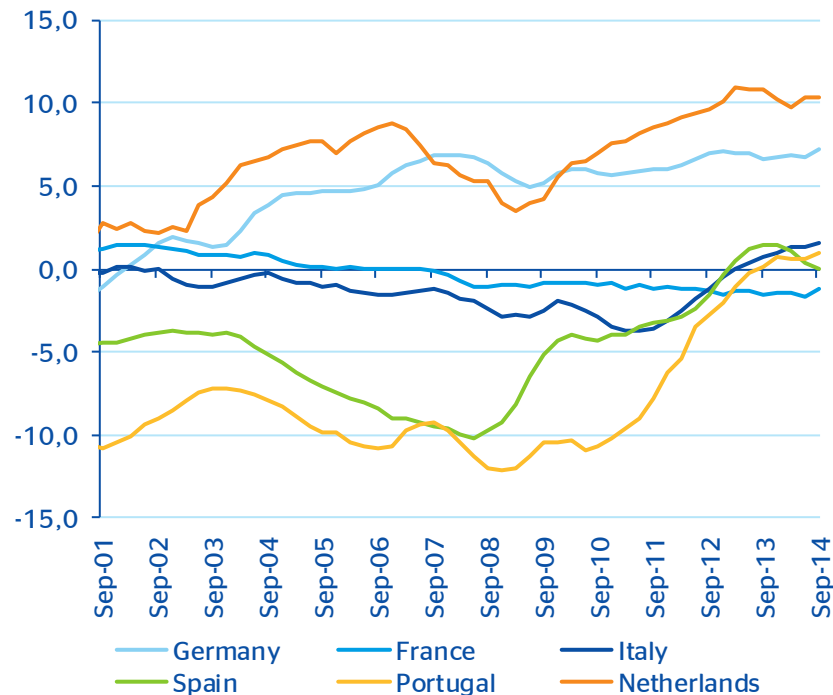
Current account deficits have disappeared very fast

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

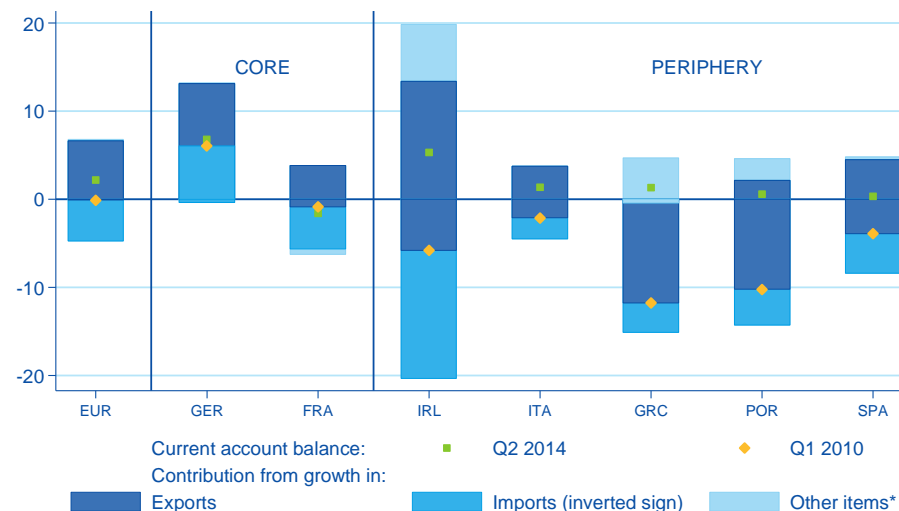
Current account (% GDP)

Sources: Eurostat and BBVA Research



Current account (% GDP)

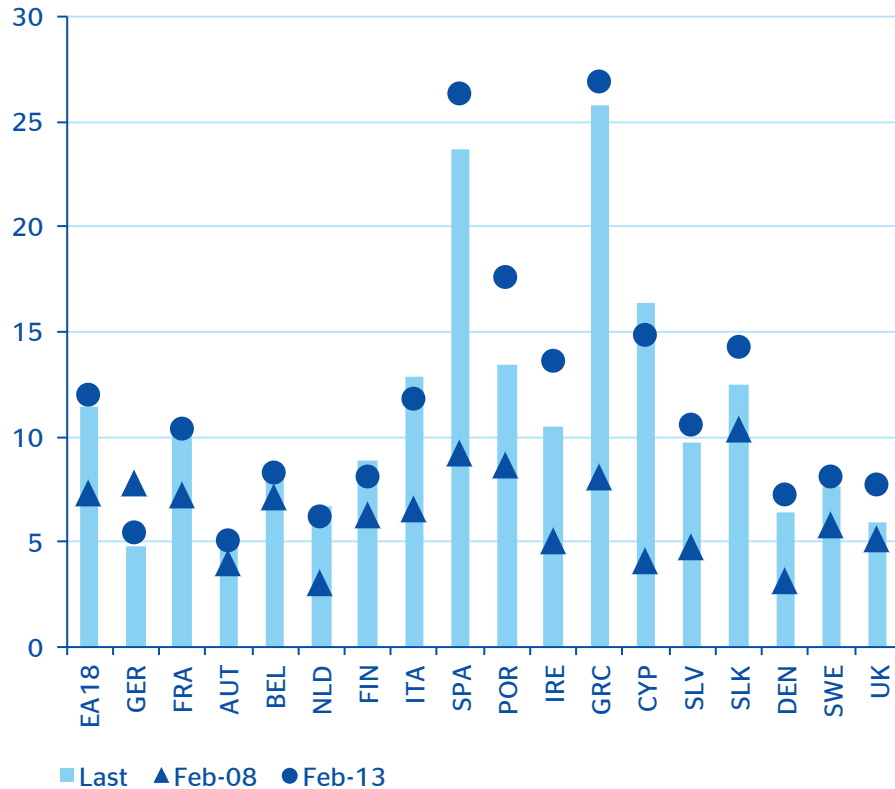
Sources: Eurostat and BBVA Research



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)

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

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... although the challenges remain

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Germany: growth gains momentum

	2013	2014 (f)	2015 (f)	2016 (f)
Activity				
REAL GDP (% YoY)	0,2	1,5	1,4	2,2
Private consumption	0,9	1,1	1,5	1,8
Public consumption	0,7	1,0	1,2	0,9
Investment	-0,4	3,1	2,0	4,0
Domestic demand (contr. %)	0,7	1,1	1,4	1,9
Exports	1,7	3,7	4,2	5,5
Imports	3,2	3,3	4,9	5,8
Net exports (contr. %)	-0,5	0,4	0,0	0,2
External sector				
Current account balance (% GDP)	6,7	7,1	7,2	6,9
Public finances				
General Govt. Balance (% GDP)	0,1	0,2	0,0	0,0
Prices				
CPI, % avg.	1,6	0,8	0,3	1,1

The strong labour market will help private consumption to increase gradually

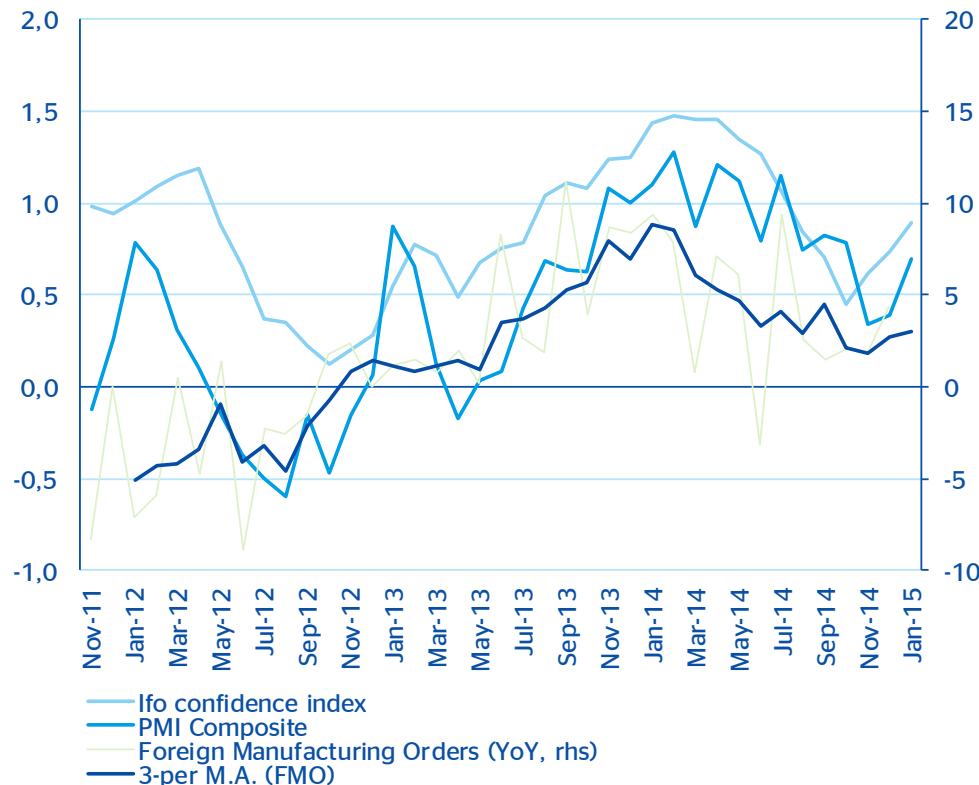
Uncertainty caused by geopolitical conflicts could lead companies to continue delaying their investment plans to 2016

Net exports will play a minor role in contributing to growth

Germany: growth in 4Q14 supported by domestic demand factors

Ifo confidence, composite PMI and manufacturing orders from abroad

Source: BBVA Research



Private consumption begins to grow at rates consistent with the favorable labor market conditions

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

France: recovery still slow in 2015

	2013	2014 (f)	2015 (f)	2016 (f)
Activity				
REAL GDP (% YoY)	0,4	0,4	1,0	1,8
Private consumption	0,3	0,4	1,3	1,4
Public consumption	2,0	2,0	1,0	1,0
Investment	-0,8	-1,5	0,0	3,5
Domestic demand (contr. %)	0,3	0,4	0,9	1,7
Exports	2,4	2,5	3,5	5,3
Imports	1,9	2,5	3,0	5,0
Net exports (contr. %)	0,1	0,0	0,1	0,0
External sector				
Current account balance (% GDP)	-1,4	-1,6	-1,5	-1,5
Public finances				
General Govt. Balance (% GDP)	-4,1	-4,4	-4,3	-3,7
Prices				
CPI, % avg.	1,0	0,6	0,1	0,9

The recovery in 2015 and 2016 will be based on domestic factors, especially consumption

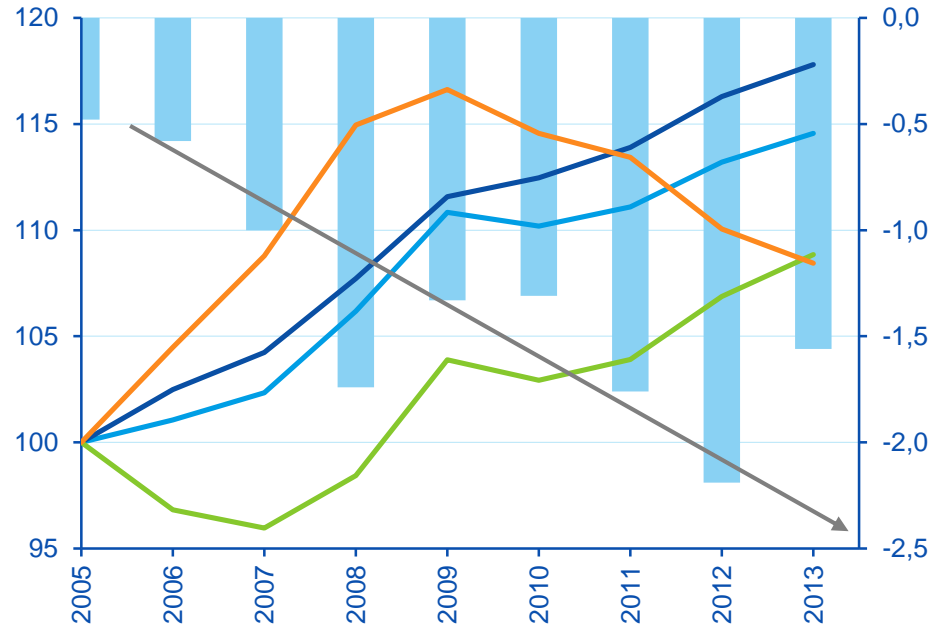
The delay in the deficit adjustment should also help

France: fiscal targets loosening to help economy recover

Unit labour costs (2005=100) and current account balance

Note: Unit labour costs normalized to 100 in 2005

Source: BBVA Research



- FRA Current Acc. Balance (%GDP) RHS
- Eurozone
- France
- Germany
- Spain

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

The planned cuts in the tax burden on employment should be financed by lower public spending

Italy: out of recession in 2015

	2013	2014 (f)	2015 (f)	2016 (f)
Activity				
REAL GDP (% YoY)	-1,9	-0,4	0,6	1,3
Private consumption	-2,7	0,2	0,5	0,8
Public consumption	-0,7	-0,4	-0,5	0,0
Investment	-5,4	-2,6	-0,5	2,7
Domestic demand (contr. %)	-2,8	-0,8	0,1	0,9
Exports	0,9	1,8	4,0	4,9
Imports	-2,6	0,3	2,5	4,0
Net exports (contr. %)	0,9	0,4	0,5	0,4
External sector				
Current account balance (% GDP)	1,0	1,1	1,3	1,9
Public finances				
General Govt. Balance (% GDP)	-2,8	-3,0	-2,7	-2,4
Prices				
CPI, % avg.	1,3	0,2	-0,2	0,6

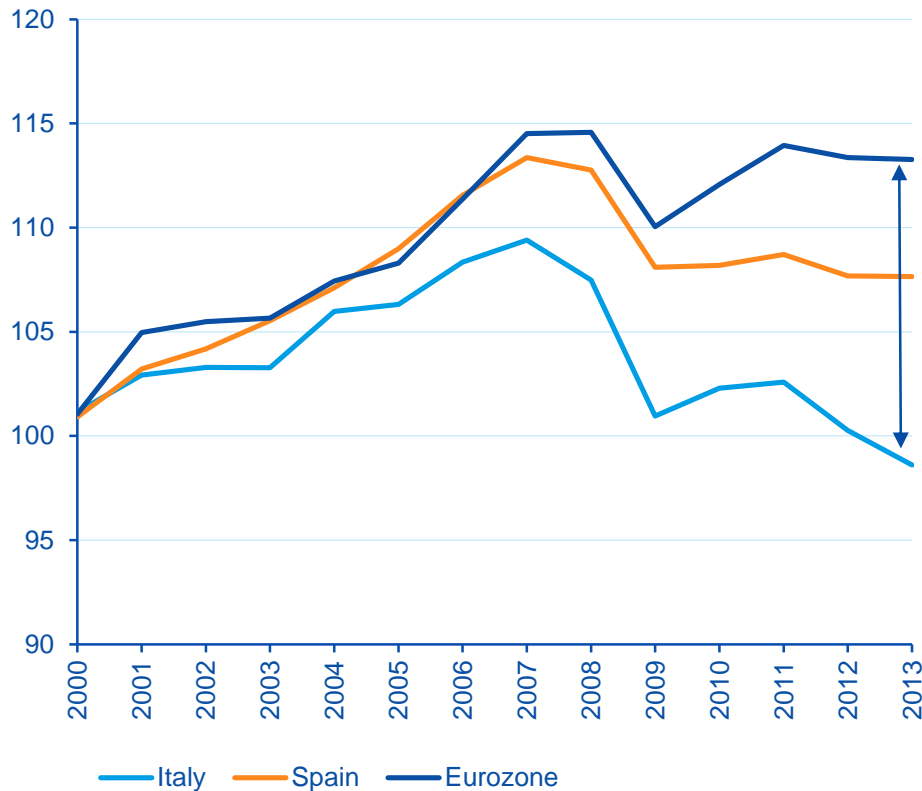
We continue to expect a slow recovery in 2015 (0.6%), driven by exports

Investment will still be affected by uncertainty linked to the slow pace of reforms

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 (132.7%), while the deficit reduction is slower than expected

The growth potential is very low

...but could recover, should fiscal and labour market reforms underway be completed

Spain: growth revision to the upside

	2013	2014 (f)	2015 (f)	2016 (f)
Activity				
REAL GDP (% YoY)	-1,2	1,4	2,7	2,7
Private consumption	-2,3	2,3	2,5	1,7
Public consumption	-2,9	0,8	1,5	1,4
Investment	-3,8	2,8	5,2	6,4
Domestic demand (contr. %)	-2,7	2,1	2,7	2,4
Exports	4,3	4,4	6,1	7,2
Imports	-0,5	7,6	6,8	7,1
Net exports (contr. %)	1,4	-0,7	0,0	0,2
External sector				
Current account balance (% GDP)	1,4	-0,2	0,9	1,0
Public finances				
General Govt. Balance (% GDP)	-6,3	-5,5	-4,2	-2,8
Prices				
CPI, % avg.	1,4	-0,2	-0,4	1,4

Both in 2015 and in 2016, activity will grow by 2.7%, supported by internal and external factors

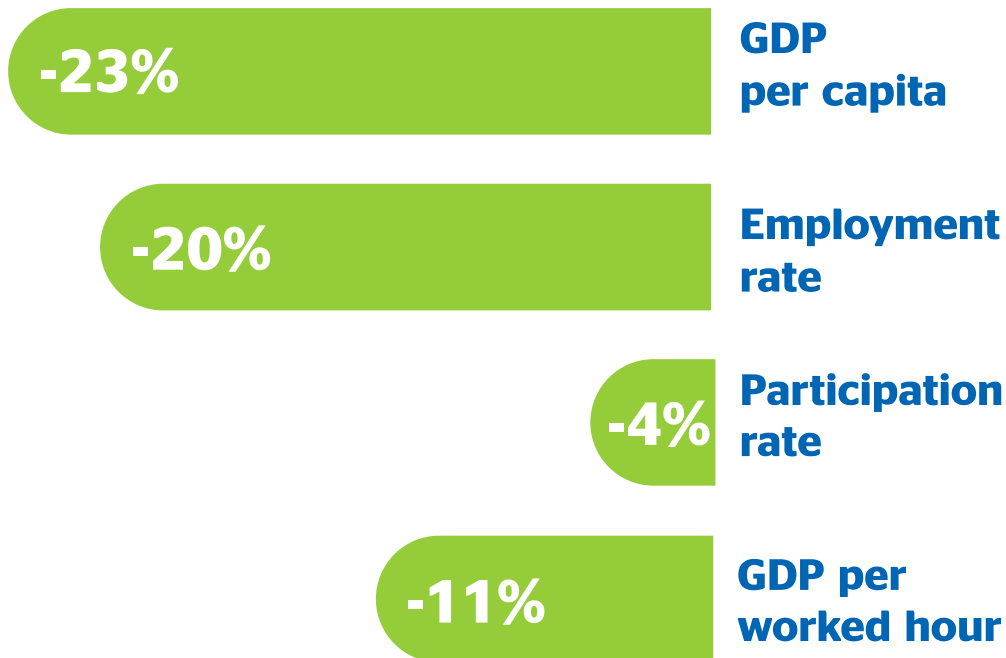
The recovery in the fundamentals and the change in tone of fiscal policy will contribute to the sustained recovery in domestic demand

The contribution of net external demand to growth will be virtually nil

Spain: the labour market is improving, but challenges remain

Spain's deviation from the EU8 in 2013

Source: BBVA Research, based on Andrés & Doménech (2014)



Between 2015 and 2016 1,000,000 jobs will be created

Spain faces the challenge of raising its employment rate and its productivity

A return to the road of convergence

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