

Europe Outlook

Third Quarter 2015



Main messages

- 1 **Moderation of global growth** and slowdown in emerging economies, with downside risks
- 2 **The recovery continues in the eurozone**, but still marked by the uncertainty around Greece
- 3 **Exports recover** after a weak 1Q15 and despite lower demand from China
- 4 **Inflation clearly below the ECB target**, that will maintain the QE until September 2016
- 5 **The situation in Greece hasn't been resolved** and the debate on the European integration process will continue

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Softer and heterogeneous global recovery with risks tilted to the downside

Section 2

Eurozone: domestic factors are conducive to growth, external drivers less so

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Forecast: the pace of recovery is firming up

Section 4

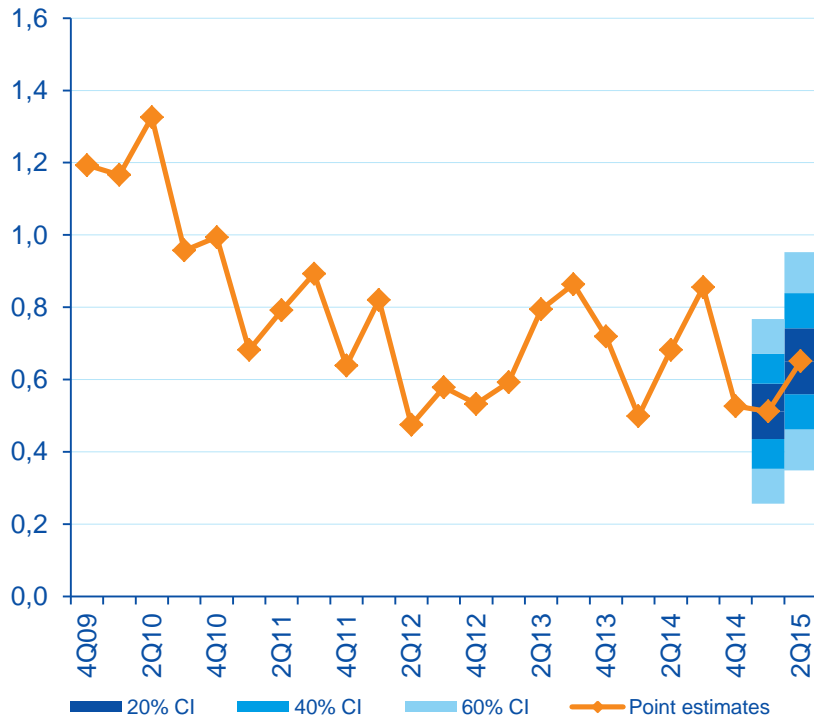
Challenges remain: low potential, large imbalances

Annex

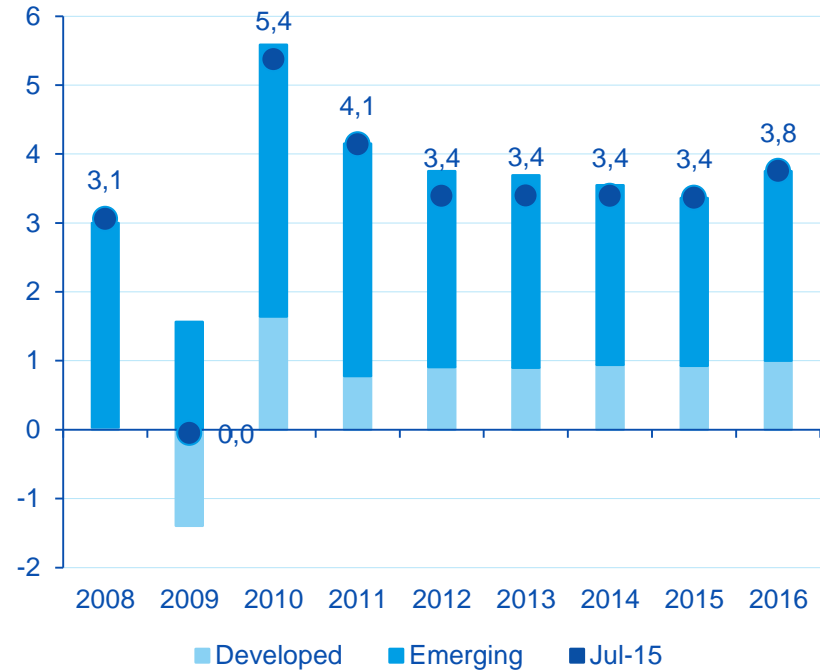
Country breakdown

Global growth slows, especially in emerging economies

World GDP growth forecast based on BBVA-GAIN (% , QoQ)
Source: BBVA Research



World GDP growth forecast (% , YoY)
Source: BBVA Research and Haver



Main features of the global economy

USA

- Uncertainty in the short term
- Labour market progresses as desired, but inflation doesn't
- Fed's first hike in September

Europe

- Strong domestic demand, lower global demand and more resilient euro
- Low inflation: QE until September 2016
- *Grexit* avoided, but uncertainty persists

China

- Lower growth...
- ... and higher risks after the stock market crisis

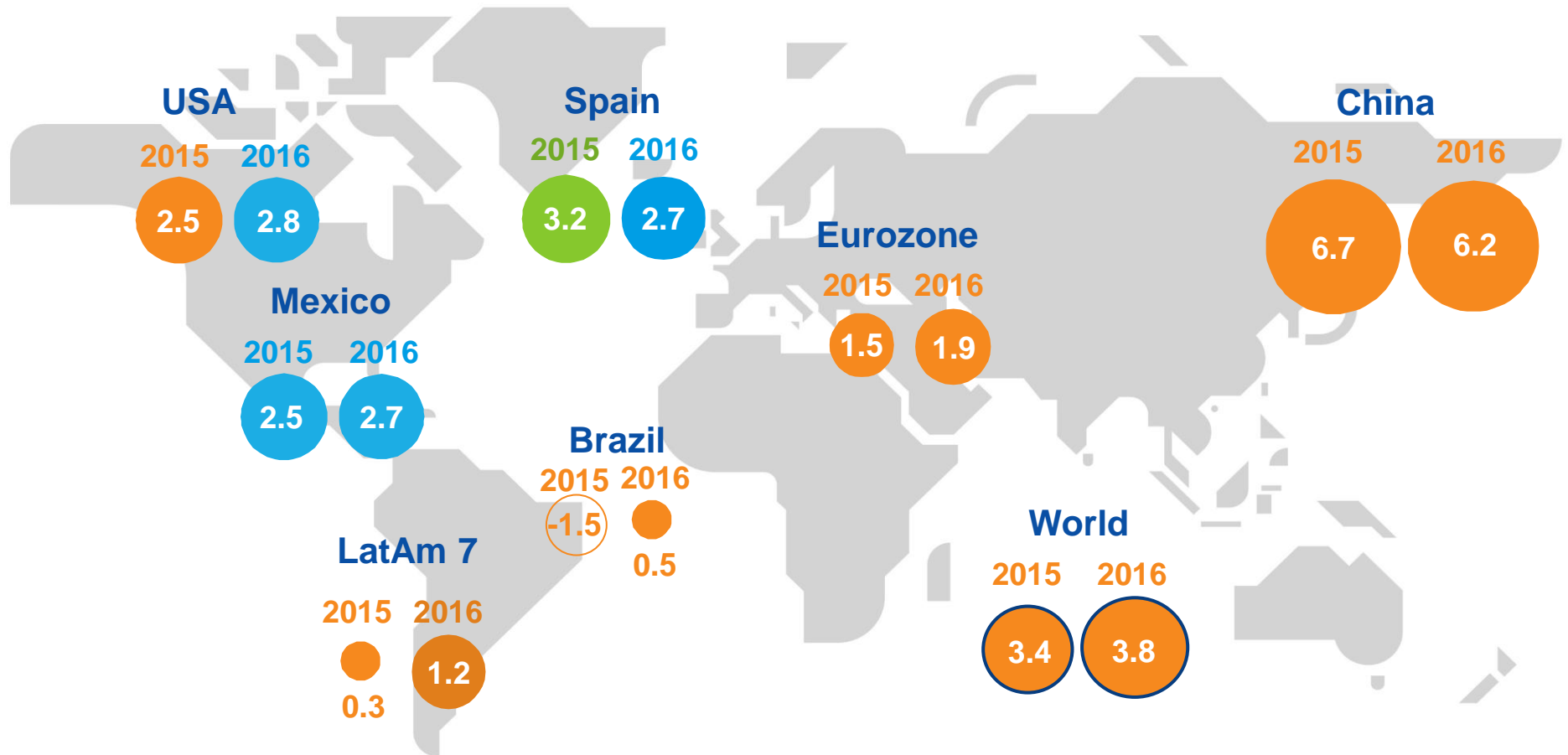
LatAm

- Less favourable global environment (China, raw materials prices, Fed)
- Uncertainty on economic policies

Emerging

- Response to Fed's hike
- Carry-over effect from China

World growth: global moderation, especially in emerging



Revisions:

● Downward

● None

● Upward

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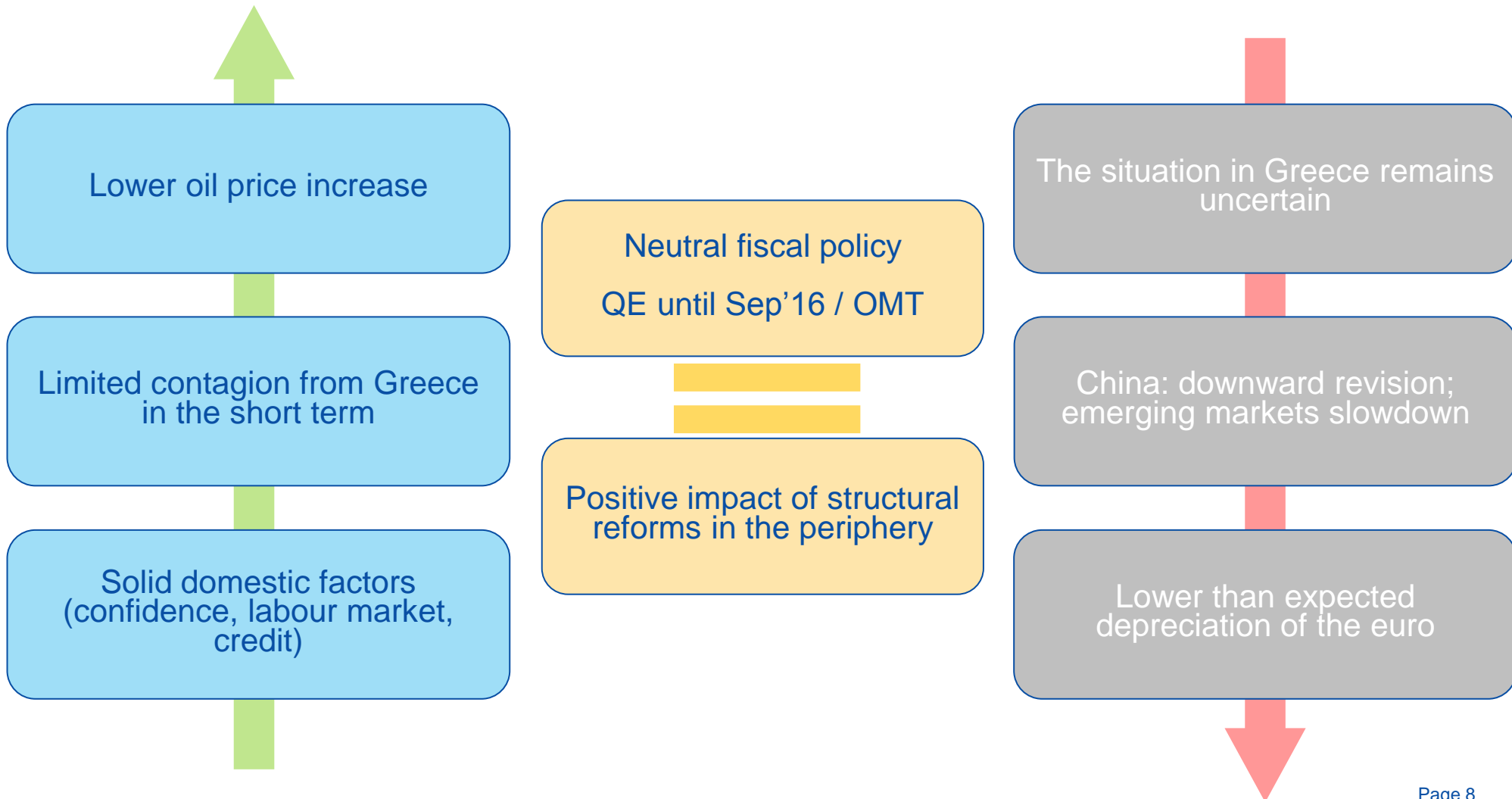
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Drivers of growth

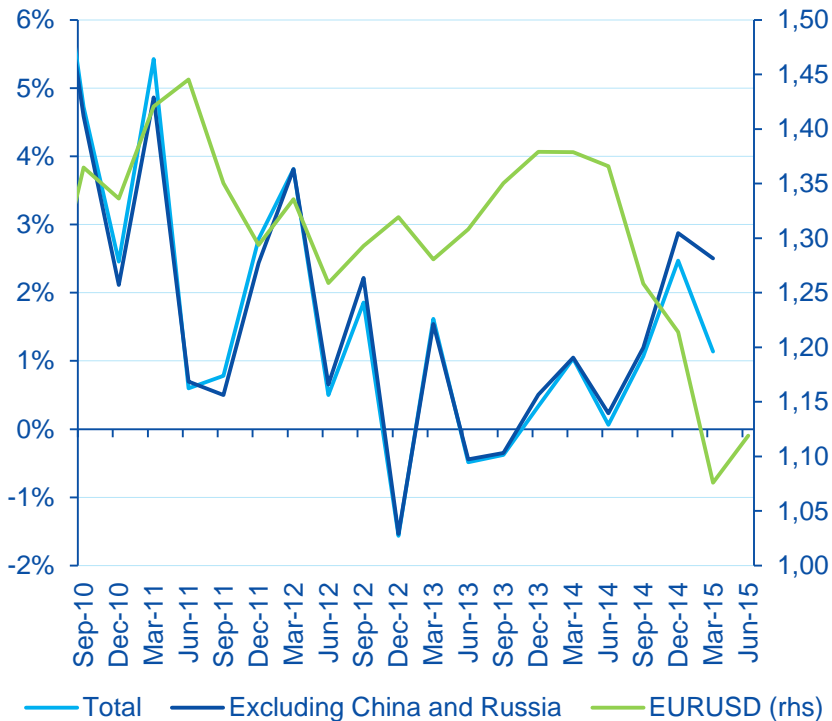


Exports to China and Russia are decreasing

The slowdown in China and Russia is having a negative impact on exports, with different effects across countries

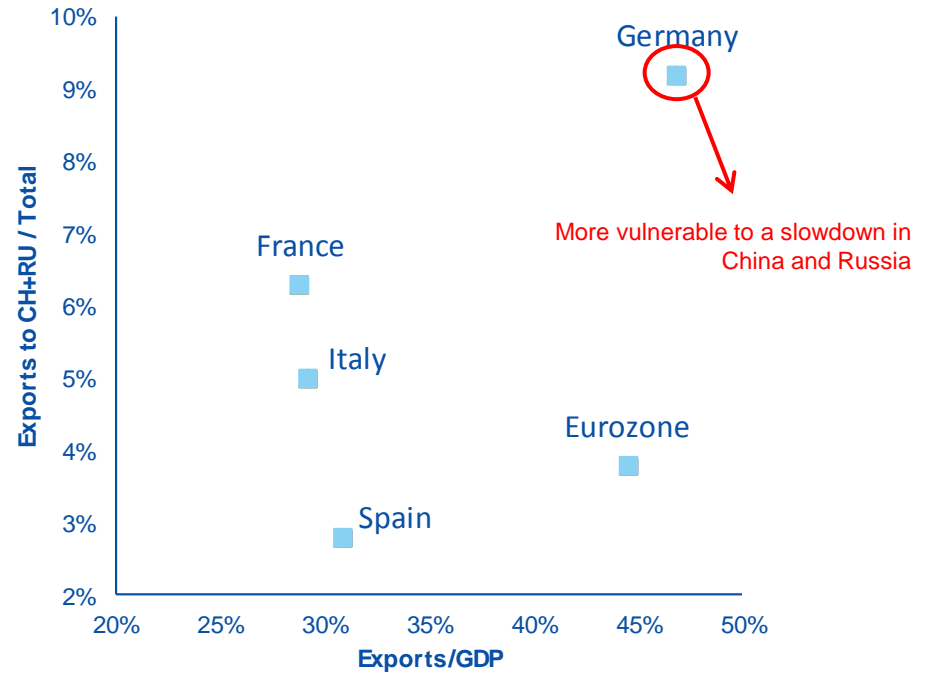
EMU: exports (% QoQ) and exchange rate

Source: BBVA Research and Eurostat



Exports: weight on GDP and share to China and Russia

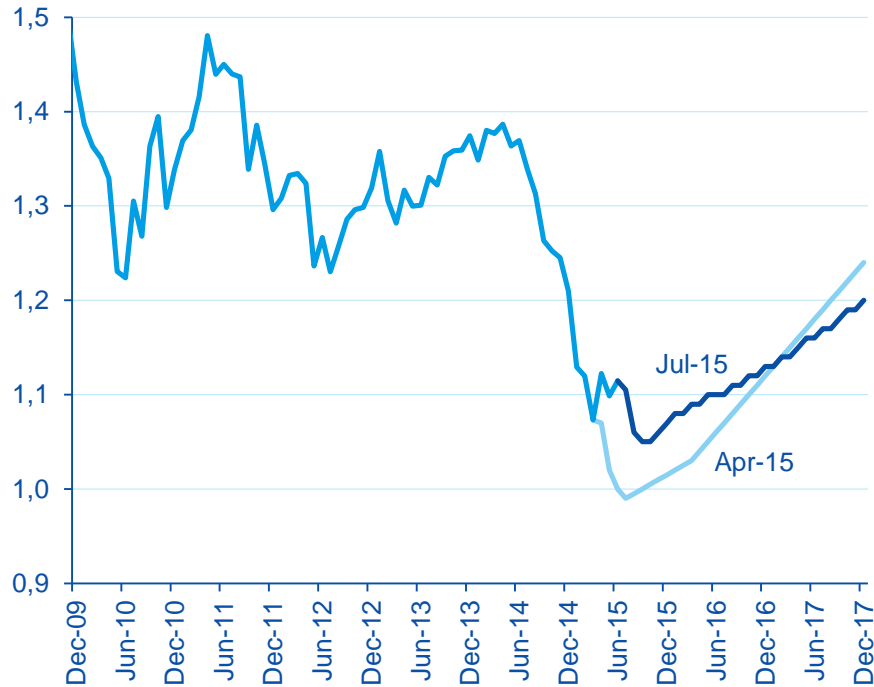
Source: BBVA Research and Eurostat



The euro with less room to run on the downside and moderation in global growth

Exchange rate (EURUSD)

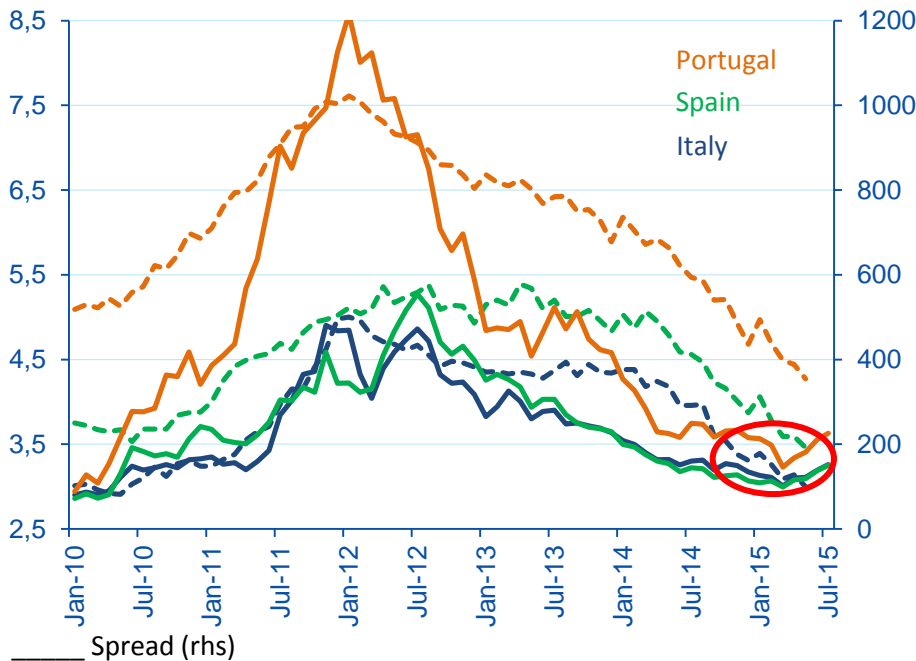
Source: BBVA Research



Limited contagion from the Greek crisis. So far, Grexit has been avoided, but with many hurdles ahead

EMU: financial tensions index

Source: BBVA Research



----- Int. rate new loans NFC<1M

Limited contagion thanks to the ECB and the improvement of European governance

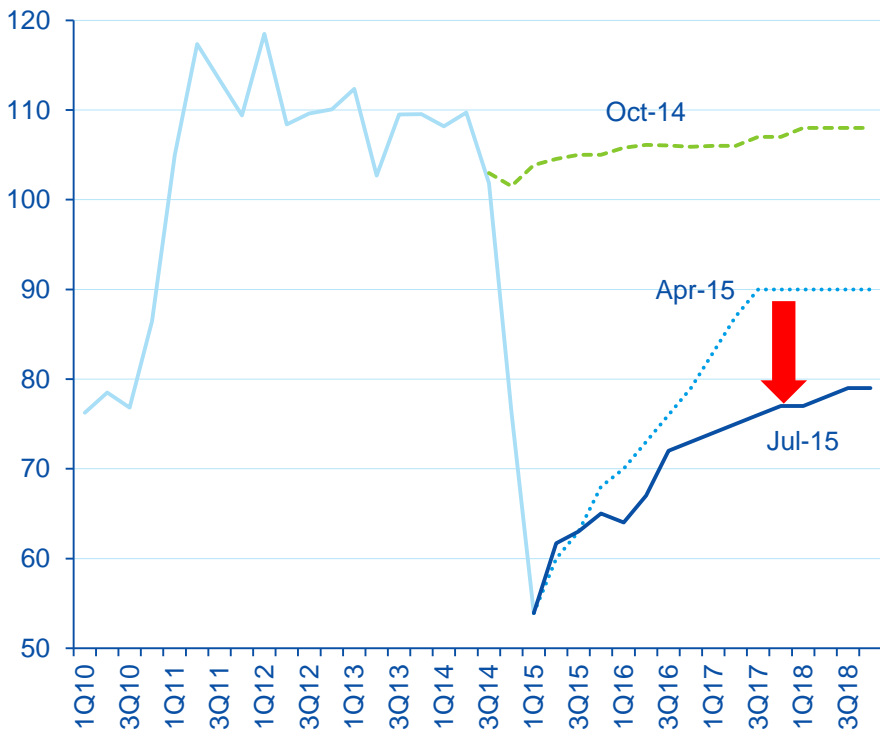
The uncertainty could weigh on the expected rebound in investment

It affects the architecture of EMU. Debate over the future of the euro (further integration)

The fall in oil prices reinforces domestic drivers

Oil price (Brent, USD/barrel)

Source: BBVA Research



Lower oil prices, with respect to three months ago, could boost GDP growth in 2016



0.1-0.2%

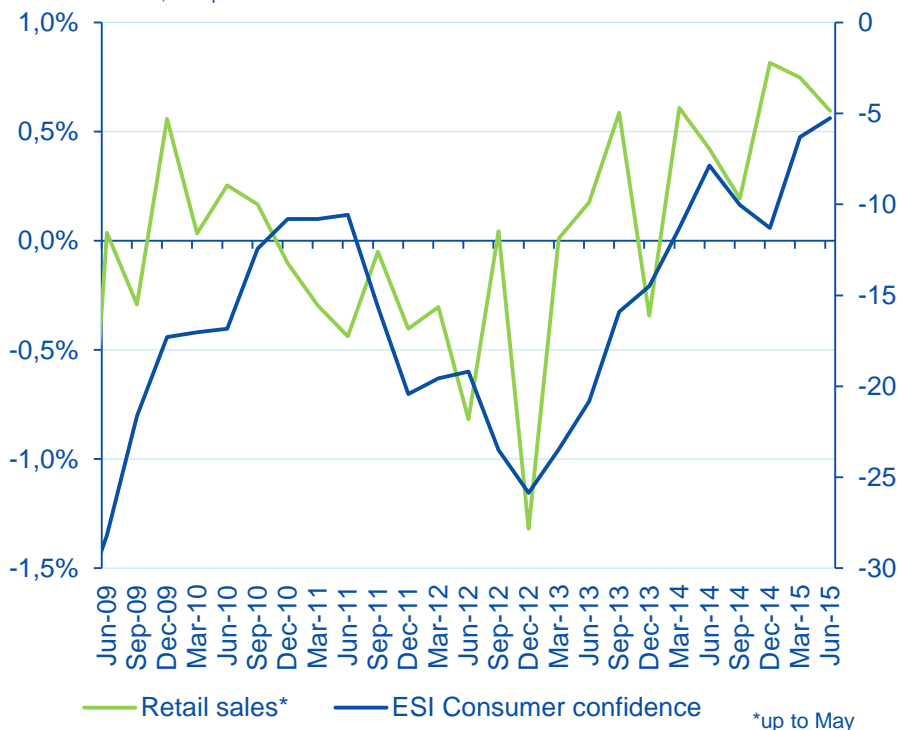
Strength of private consumption

Retail sales continue to grow at a robust pace

Real earnings increased again in 1Q15 driven by employment, moderate wages and lower prices

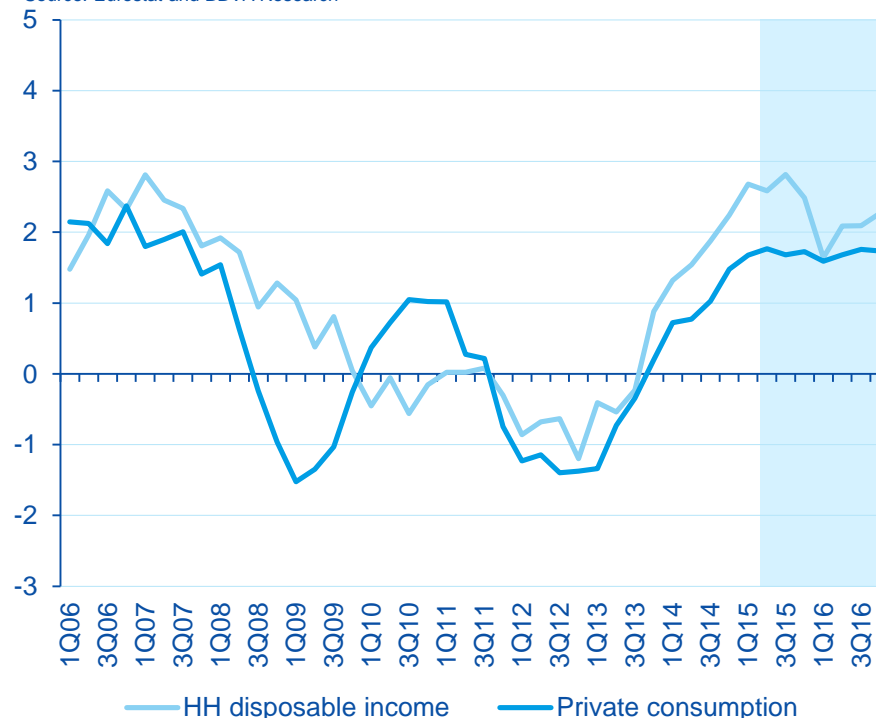
EMU: retail sales (% QoQ) and ESI consumer confidence

Source: Eurostat, European Commission and BBVA Research



EMU: private consumption and real labour earnings (% YoY)

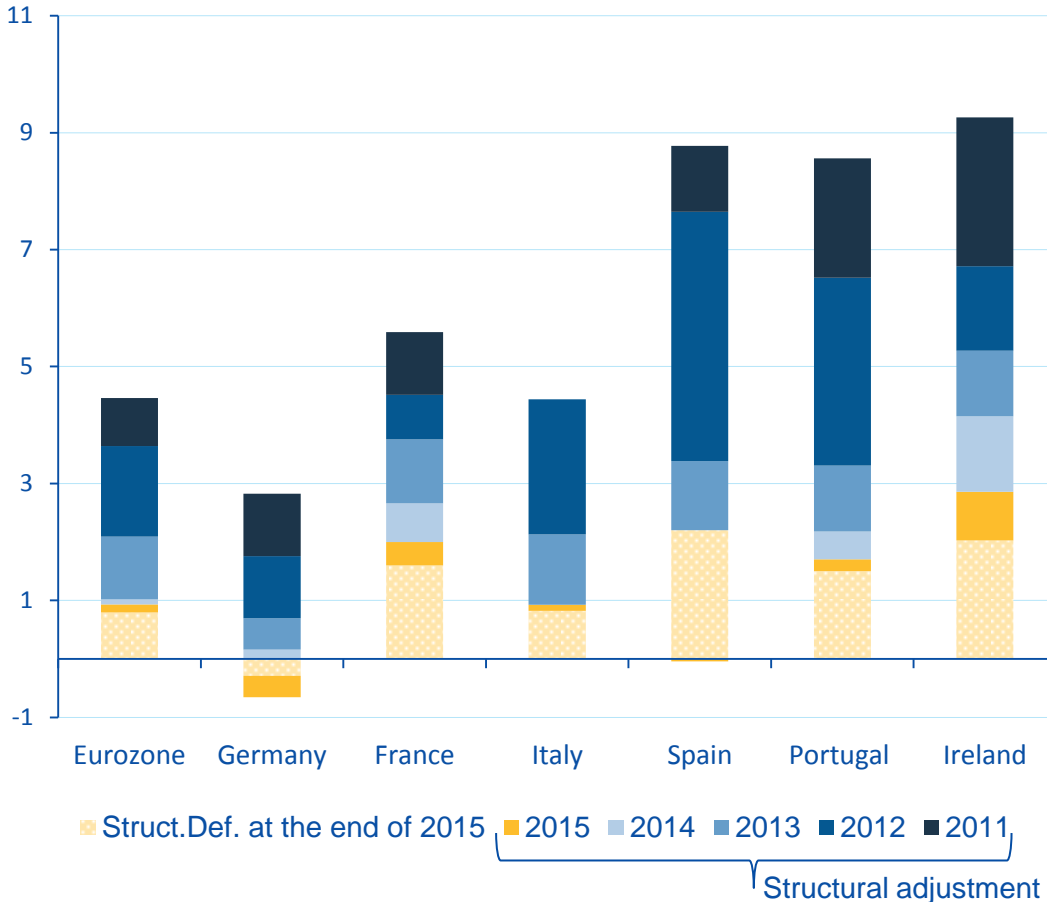
Source: Eurostat and BBVA Research



More favourable fiscal policy than in previous years

EMU: structural deficit adjustment 2010-2015 (%GDP)

Source: BBVA Research and IMF



Almost neutral fiscal policy in 2015

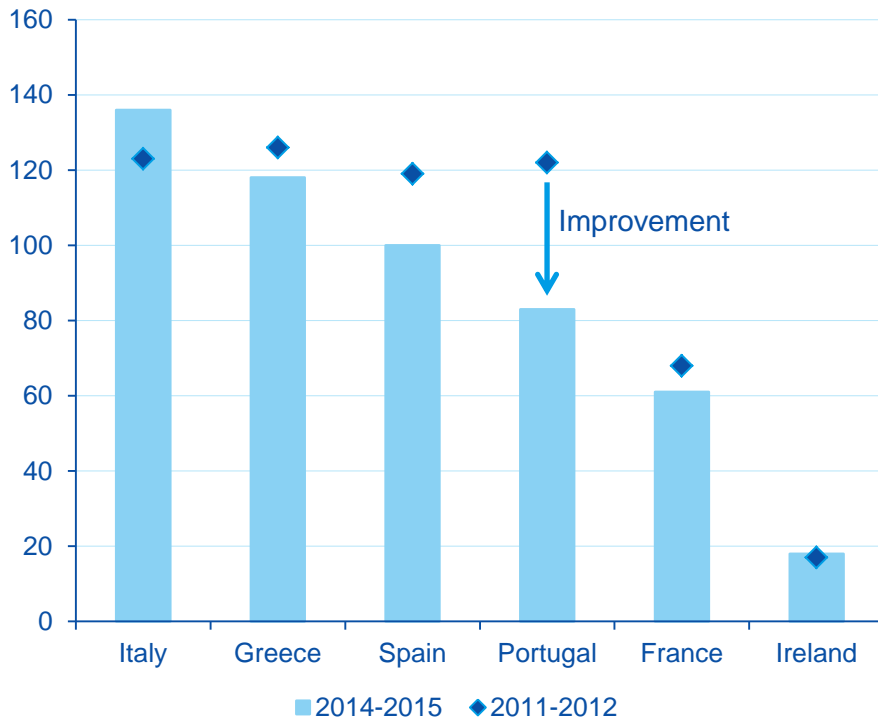
European Commission wiser not to force a procyclical adjustment

Relaxation of fiscal effort in exchange for structural reforms

Structural reforms are starting to bear fruit in the periphery

Labour market efficiency index, ranking

Source: IMF, WEO, 2014-2015



Peripheral countries begin to benefit from the approved reforms

Implementation in countries under programme has progressed rapidly

Spain will grow 3.2% in 2015, compared with 1.5% in Germany, 1.3% in France and somewhat below 1% in Italy

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Challenges remain: low potential, large imbalances

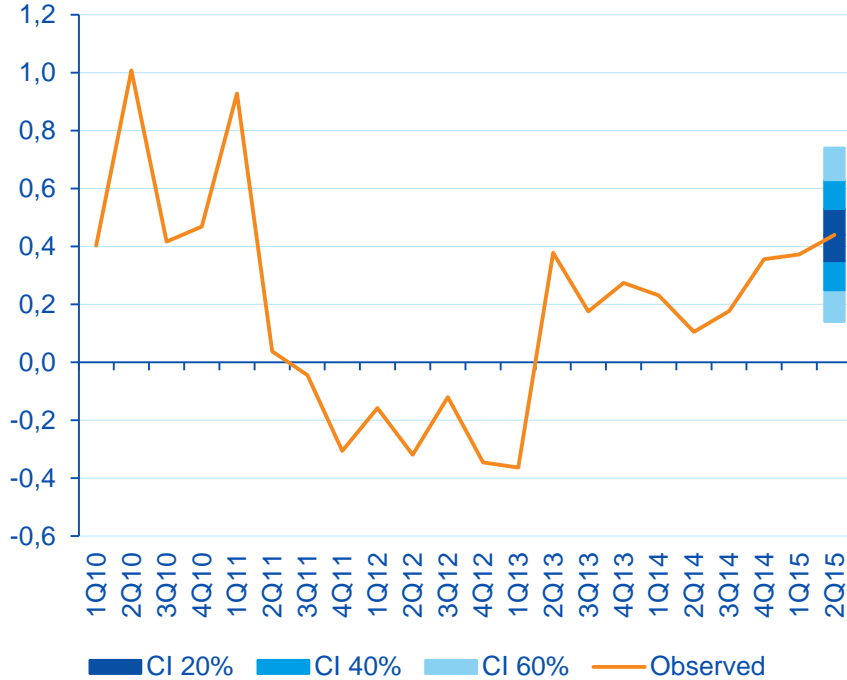
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Country breakdown

Some convergence in the pace of recovery among countries in the first half of 2015

EMU: GDP based on MICA-BBVA short term model (% QoQ)

Source: Haver and BBVA Research



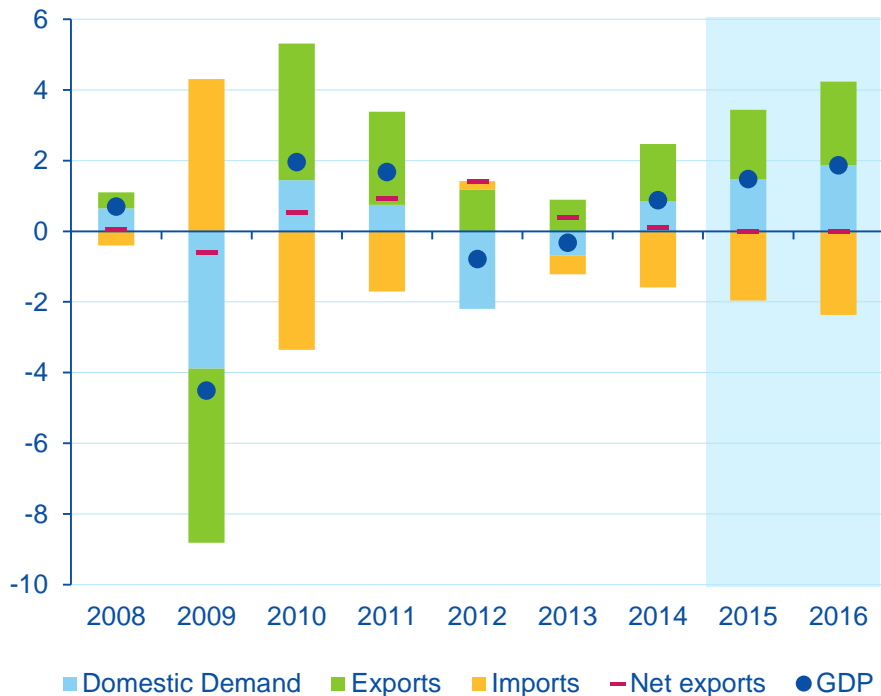
| GDP growth (QoQ) | 3Q14 | 4Q14 | 1Q15 | 2Q15 (f) |
|------------------|-------|------|------|----------|
| Eurozone | 0.2% | 0.4% | 0.4% | 0.4% |
| Germany | 0.1% | 0.7% | 0.3% | 0.5% |
| France | 0.2% | 0.1% | 0.6% | 0.3% |
| Italy | -0.1% | 0.0% | 0.3% | 0.4% |
| Spain | 0.5% | 0.7% | 0.9% | 1.0% |

Source: Eurostat and BBVA Research

Forecast: investment will begin to support growth

EMU: annual GDP growth contributions (pp)

Source: Eurostat and BBVA Research



| | 2013 | 2014 | 2015 (f) | 2016 (f) |
|--|------|------|----------|----------|
|--|------|------|----------|----------|

Activity

| | | | | |
|----------------------------|-------------|------------|------------|------------|
| Real GDP (% YoY) | -0.3 | 0.9 | 1.5 | 1.9 |
| Private consumption | -0.6 | 1.0 | 1.7 | 1.7 |
| Public consumption | 0.2 | 0.6 | 0.8 | 0.8 |
| Investment | -2.3 | 1.2 | 1.9 | 3.9 |
| Domestic demand (contr. %) | -0.7 | 0.9 | 1.5 | 1.9 |
| Exports | 2.1 | 3.7 | 4.4 | 5.1 |
| Imports | 1.3 | 4.0 | 4.8 | 5.6 |
| Net exports (contr. %) | 0.4 | 0.0 | 0.0 | 0.0 |

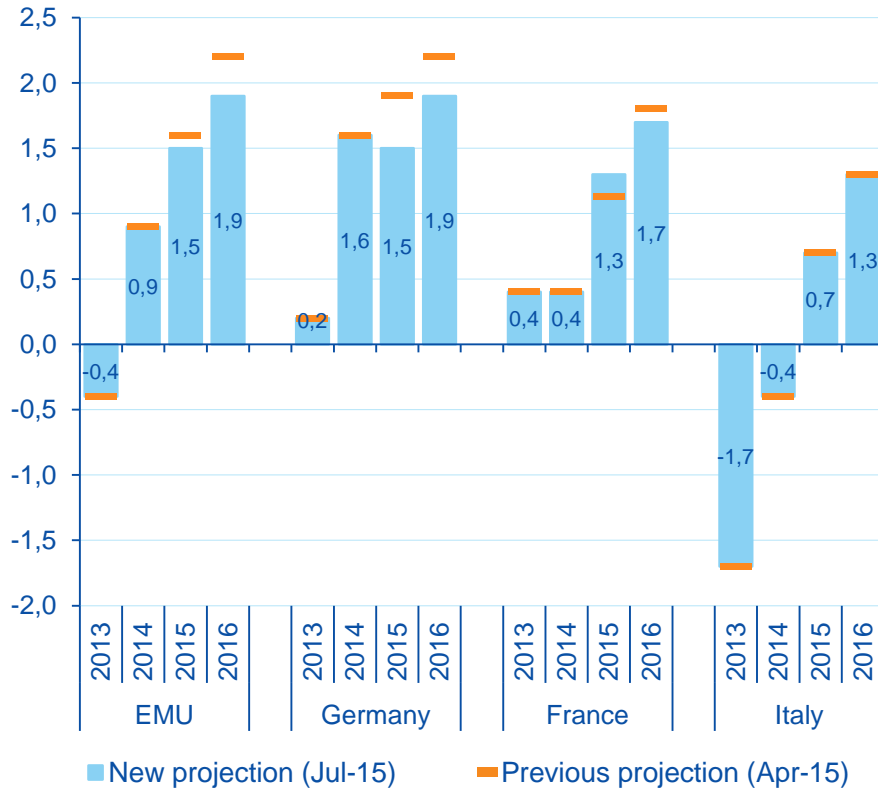
| | | | | |
|--|------|------|------|------|
| Current account balance (% GDP) | 1.8 | 2.1 | 2.6 | 2.5 |
| Public deficit (% GDP) | -2.9 | -2.4 | -2.2 | -1.8 |
| HCPI, % average | 1.4 | 0.4 | 0.3 | 1.3 |

Source: Eurostat and BBVA Research

Among countries, Germany will continue stronger than France and Italy

EMU: GDP forecast by country (%)

Sources: Eurostat and BBVA Research



Germany: solid growth based on domestic factors, but the slowdown in global demand will be noticeable

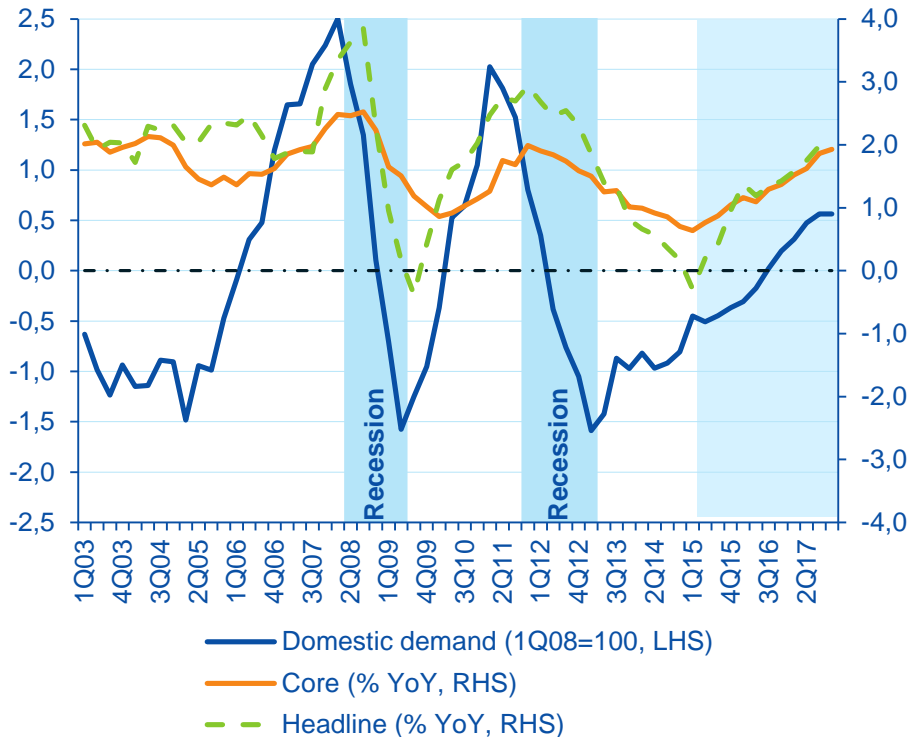
France: more stable growth in 2016, with investment taking over the strong support of consumption

Italy: oil price and ongoing reforms will boost the role of domestic demand recovery

Very low inflation in 2015, below the ECB's target in the forecast horizon

EMU: demand and inflation

Source: Eurostat and BBVA Research



Slight upward revision to 0.3% in 2015 (+ 0.2 pp), unchanged in 2016 (1.3%)

Positive surprise in 1Q15 due to energy and food. This increases the forecast for 2015, but would be offset by lower oil prices and somewhat stronger euro

Downside risks in the short term, but deflation risk vanishes

Europe faces significant challenges and risks



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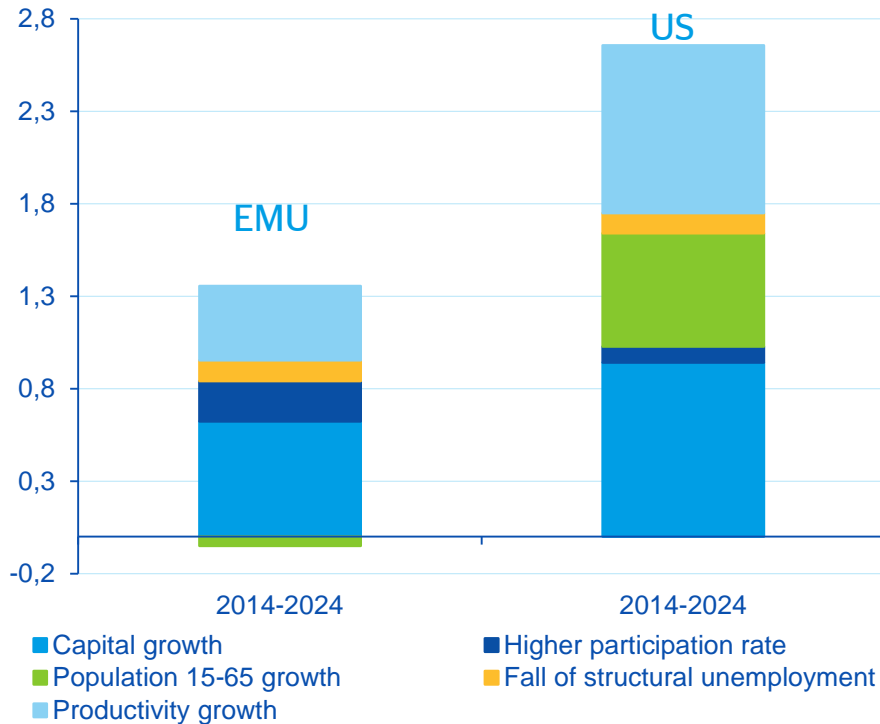
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Lower growth potential in the eurozone than in the US

GDP growth potential projection (pp)

Sources: Eurostat and BBVA Research



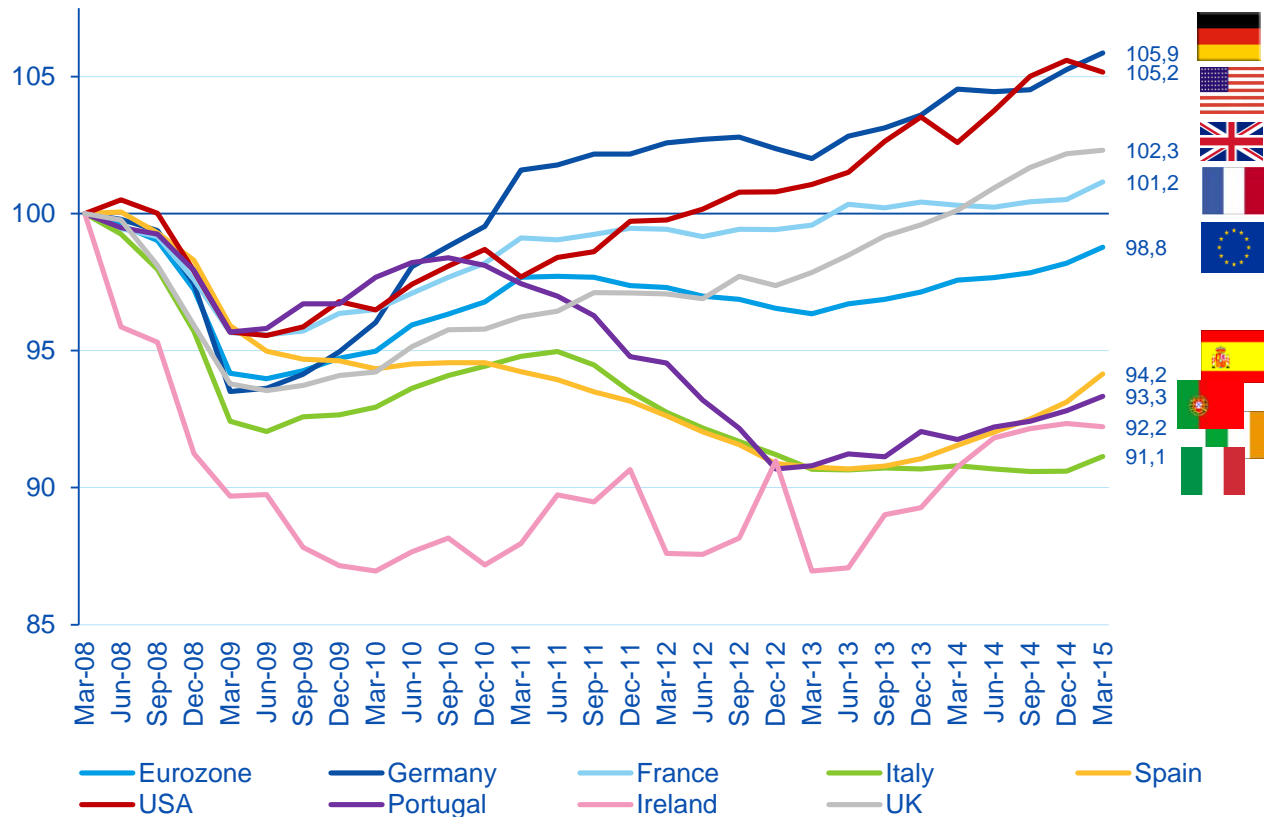
Potential well below US figures

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

Where do we stand after the crisis?

GDP per working age population (Q1-2008=100)

Sources: Eurostat, Haver and BBVA Research



Few imbalances haven't been corrected yet

| | Public Debt % of GDP Q1-2015 | Public Deficit* % of GDP 2014 | Unemploy- ment rate %AP Latest | Current Account % of GDP Q1-2015 | Net International Investment Position % of GDP 2014 | Real effective exchange rate % YoY chg. Q4-2014 | Nominal Unit Labour Cost % YoY chg. Q1-2015 | Household Debt % of GDP Latest | Non-Financial Corporations Debt % of GDP Latest |
|----------|------------------------------------|-------------------------------------|---|---|--|--|--|--------------------------------------|---|
| Eurozone | 92,7 | -2,4 | 11,1 | 2,3 | -12,2 | 1,0 | 1,1 | 63,9 | 81,5 |
| GER | 74,4 | 0,7 | 4,7 | 7,8 | 36,4 | -0,3 | 2,0 | 55,1 | 49,4 |
| FRA | 97,5 | -4,0 | 10,3 | -0,5 | -16,4 | -1,2 | 0,4 | 54,7 | 96,4 |
| AUT | 84,9 | -2,4 | 6,0 | 1,7 | 2,1 | 1,9 | 1,7 | 50,3 | 80,3 |
| BEL | 111,0 | -3,2 | 8,6 | 2,5 | 54,7 | -0,5 | -1,3 | 56,5 | 140,1 |
| NED | 68,9 | -2,3 | 6,9 | 10,9 | 65,8 | 0,8 | -1,0 | 115,7 | 113,8 |
| FIN | 60,3 | -3,2 | 9,4 | -1,5 | 0,4 | 2,7 | 1,3 | 64,5 | 91,1 |
| ITA | 132,1 | -3,0 | 12,4 | 2,0 | -27,7 | 0,2 | 1,4 | 42,8 | 69,1 |
| SPA | 98,0 | -5,8 | 22,5 | 1,0 | -93,5 | -1,0 | 0,8 | 70,7 | 109,1 |
| POR | 129,6 | -4,5 | 13,2 | 1,0 | -111,6 | -1,8 | 0,1 | 79,7 | 106,1 |
| IRE | 109,7 | -4,1 | 9,8 | 6,2 | -97,5 | -3,5 | 0,3 | 88,5 | 194,6 |
| GRC | 168,8 | -3,5 | 25,6 | 0,3 | -121,9 | -5,6 | 1,2 | 62,3 | 66,0 |
| CYP | 106,8 | -8,8 | 16,0 | -4,6 | -165,1 | -1,4 | -1,7 | 123,1 | 220,9 |
| SLV | 81,9 | -4,9 | 9,2 | 6,8 | -44,7 | 1,2 | -1,5 | 28,3 | 70,4 |
| SLK | 54,0 | -2,9 | 11,8 | -0,1 | -70,0 | 1,3 | 0,4 | 29,2 | 44,2 |
| DEN | 44,4 | 1,2 | 6,2 | 6,8 | 41,8 | -1,2 | 0,9 | 133,0 | 84,0 |
| SWE | 44,0 | -1,9 | 7,8 | 7,1 | -4,0 | -3,7 | 1,7 | 83,3 | 145,0 |

Colour criterion:

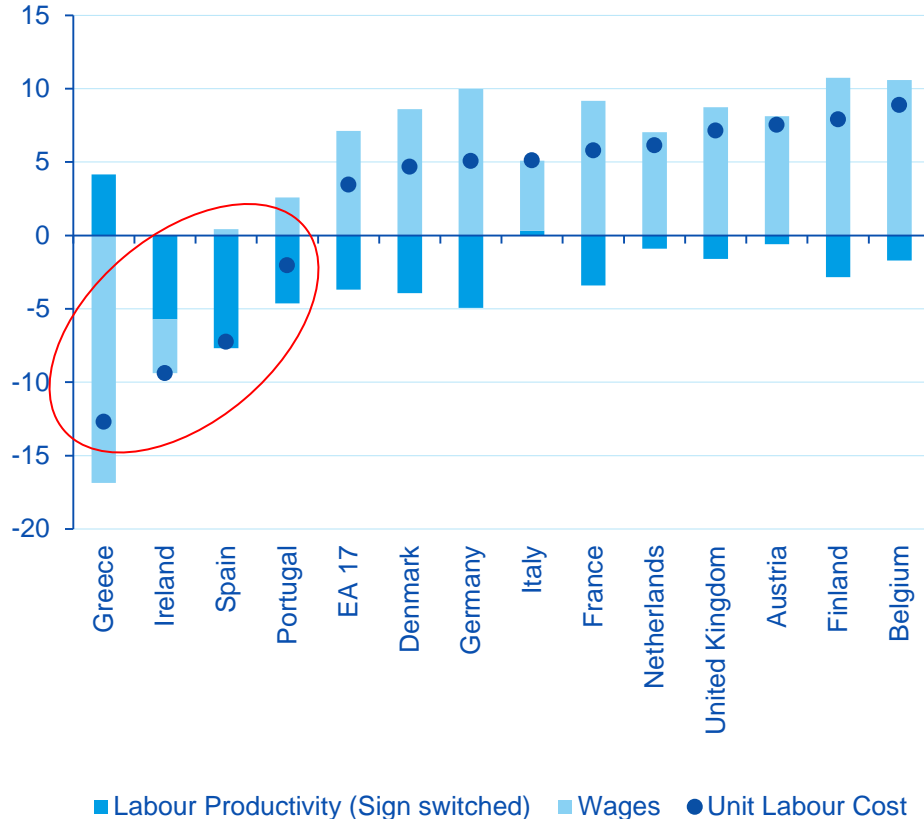
| | | | | | | | | |
|-----------------|----------------|----------------|----------------|-----------------|----------------|----------------|------------------|------------------|
| Higher than 130 | Lower than -6 | Higher than 16 | Lower than -6 | Lower than -100 | Greater than 6 | Greater than 9 | 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 assistance to financial sector
Source: Eurostat, ECB, Haver and BBVA Research

Unit labor costs and current account deficits have been adjusted in the periphery

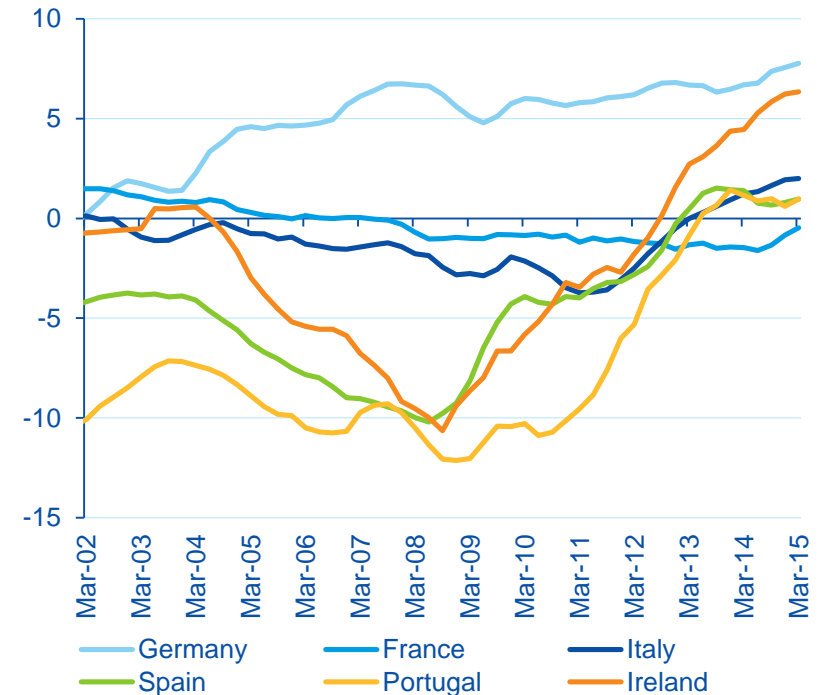
ULC adjustment, 2009-2013 (%)

Source: Haver and BBVA Research



Current account (% GDP)

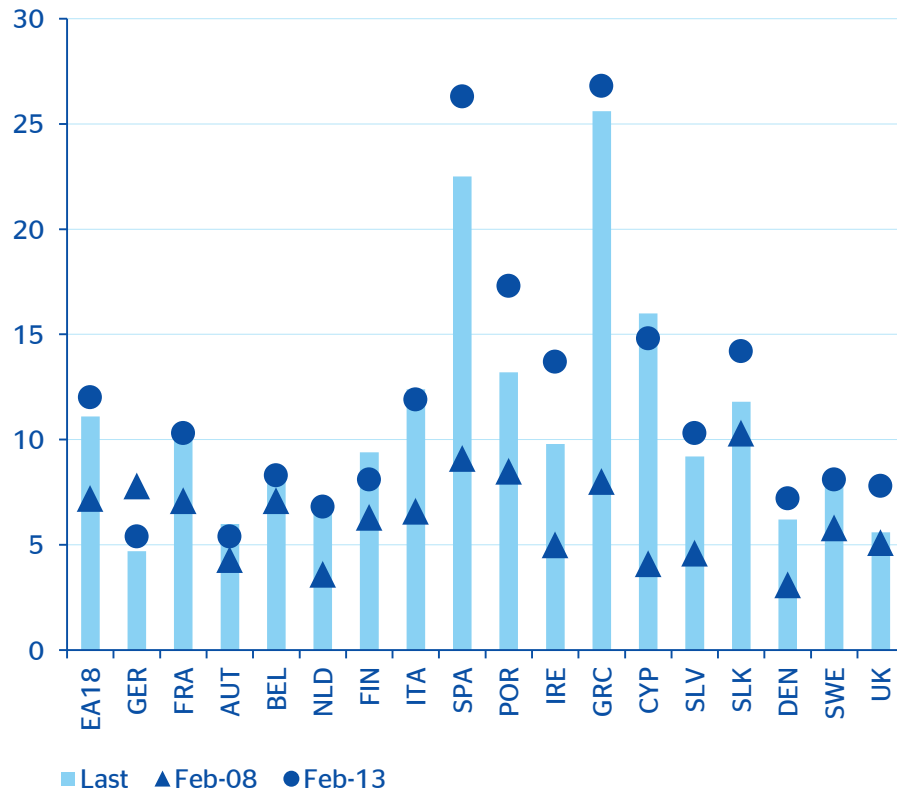
Source: Eurostat and BBVA Research



High unemployment remains the main problem of economic policy

Unemployment since the beginning of the crisis (%)

Source: Haver and BBVA Research



The unemployment rate is much higher than in 2008 (except in Germany)

Still, it has begun to decline earlier than in past recoveries

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Germany: robust domestic fundamental

| | 2013 | 2014 | 2015 (f) | 2016 (f) |
|--------------------------------------|-------------|------------|-------------|------------|
| Activity | | | | |
| Real GDP (%YoY) | 0.2 | 1.6 | 1.5 | 1.9 |
| Private consumption | 0.9 | 1.2 | 2.0 | 1.8 |
| Public consumption | 0.7 | 1.1 | 1.4 | 0.9 |
| Investment | -0.4 | 3.4 | 1.9 | 3.8 |
| <i>Domestic demand (contr. %)</i> | 0.7 | 1.2 | 1.7 | 1.9 |
| Exports | 1.7 | 3.8 | 4.1 | 5.2 |
| Imports | 3.2 | 3.3 | 5.2 | 6.0 |
| <i>Net exports (contr. %)</i> | -0.5 | 0.4 | -0.2 | 0.0 |
| External sector | | | | |
| Current account bal. (% GDP) | 6.5 | 7.6 | 7.7 | 7.2 |
| Public finances | | | | |
| General Govt. balance (% GDP) | 0.1 | 0.7 | 0.3 | -0.1 |
| Prices | | | | |
| HCPI, % average | 1.6 | 0.8 | 0.5 | 1.4 |

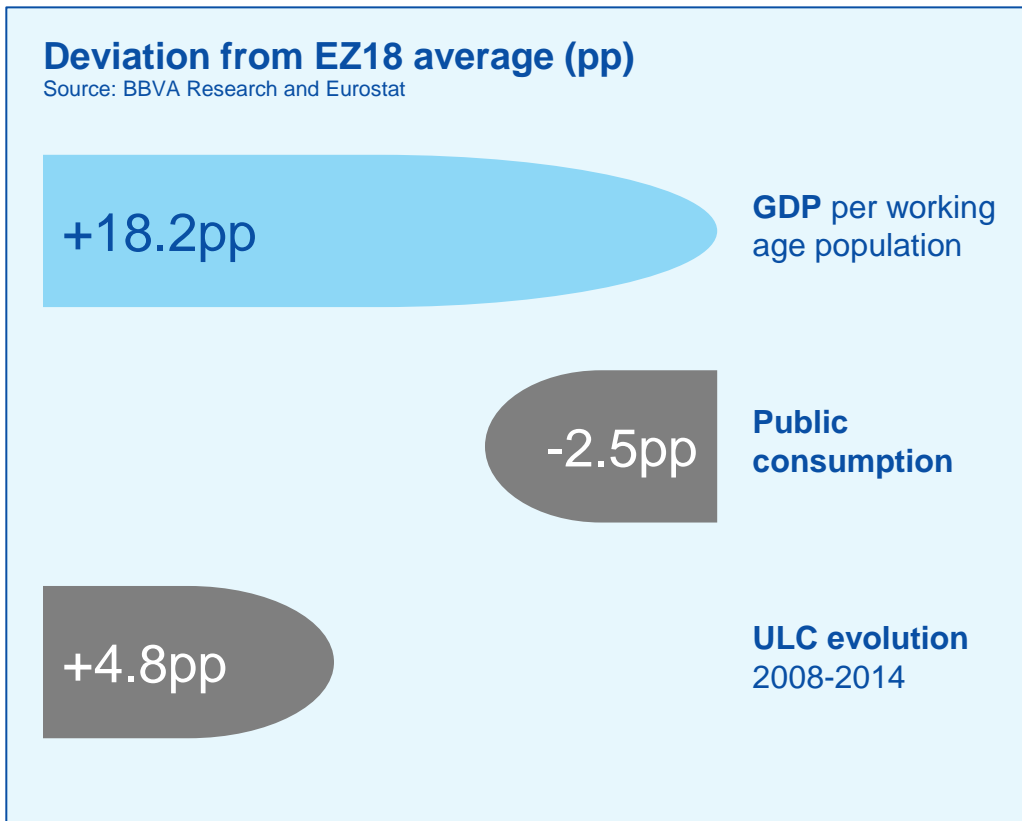
Source: Eurostat and BBVA Research

Private consumption continues to grow at rates consistent with favorable labour market conditions

Lower demand from Russia and China hampers the growth of exports

The uncertainty caused by geopolitical conflicts could lead businesses to further delay their investment plans to 2016

Germany: solid labour market



The positive divergence with the average of the area is gradually expanding

Increased public investment would help correct the current account surplus

The competitive advantages of German companies from the rest of EMU have been reduced, mainly since 2012

France: more balanced growth in 2016

| | 2013 | 2014 | 2015 (f) | 2016 (f) |
|--------------------------------------|------------|-------------|-------------|------------|
| Activity | | | | |
| Real GDP (%YoY) | 0.7 | 0.2 | 1.3 | 1.7 |
| Private consumption | 0.5 | 0.7 | 1.9 | 1.4 |
| Public consumption | 1.7 | 1.5 | 1.7 | 1.0 |
| Investment | -0.4 | -1.2 | -0.3 | 3.3 |
| Domestic demand (contr. %) | 0.8 | 0.7 | 1.5 | 1.7 |
| Exports | 1.8 | 2.4 | 4.9 | 5.0 |
| Imports | 1.8 | 3.9 | 5.1 | 4.7 |
| Net exports (contr. %) | 0.0 | -0.5 | -0.2 | 0.0 |
| External sector | | | | |
| Current account bal. (% GDP) | -1.4 | -0.8 | -0.9 | -0.8 |
| Public finances | | | | |
| General Govt. balance (% GDP) | -4.1 | -4.0 | -3.6 | -3.0 |
| Prices | | | | |
| HCPI, % average | 1.0 | 0.6 | 0.3 | 1.2 |

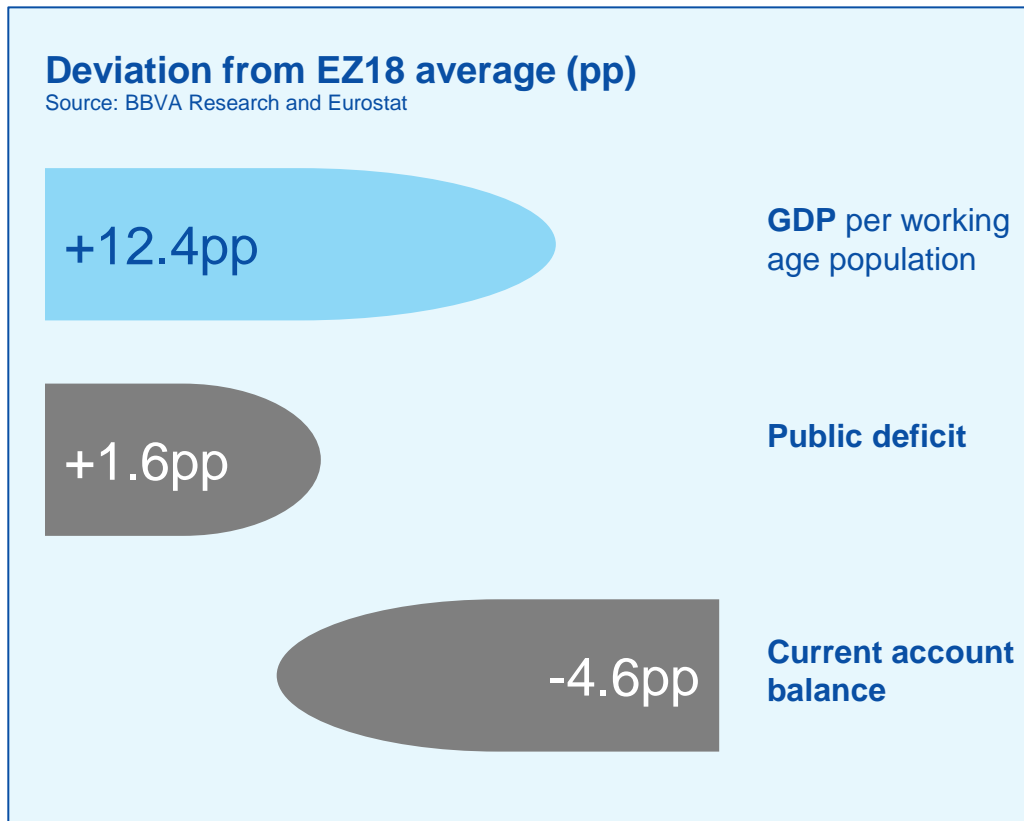
Source: Eurostat and BBVA Research

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

The delay in the adjustment of the deficit should also help

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

France: the easing of fiscal targets will help the economy recover



Stable income above average

Timid reforms underway

France has failed to correct the current account deficit in recent years, as other countries did

Italy: moderate growth in 2015

| | 2013 | 2014 | 2015 (f) | 2016 (f) |
|--------------------------------------|-------------|-------------|------------|------------|
| Activity | | | | |
| Real GDP (%YoY) | -1.7 | -0.4 | 0.7 | 1.3 |
| Private consumption | -2.8 | 0.3 | 0.6 | 0.8 |
| Public consumption | -0.3 | -1.0 | -0.3 | 0.0 |
| Investment | -5.8 | -3.2 | 0.6 | 3.0 |
| <i>Domestic demand (contr. %)</i> | -2.5 | -0.6 | 0.5 | 0.9 |
| Exports | 0.7 | 2.4 | 3.5 | 4.3 |
| Imports | -2.2 | 1.7 | 2.9 | 3.4 |
| <i>Net exports (contr. %)</i> | 0.8 | 0.2 | 0.3 | 0.4 |
| External sector | | | | |
| Current account bal. (% GDP) | 0.9 | 1.9 | 2.1 | 2.4 |
| Public finances | | | | |
| General Govt. balance (% GDP) | -2.9 | -3.0 | -3.0 | -2.4 |
| Prices | | | | |
| HCPI, % average | 1.3 | 0.2 | 0.2 | 1.1 |

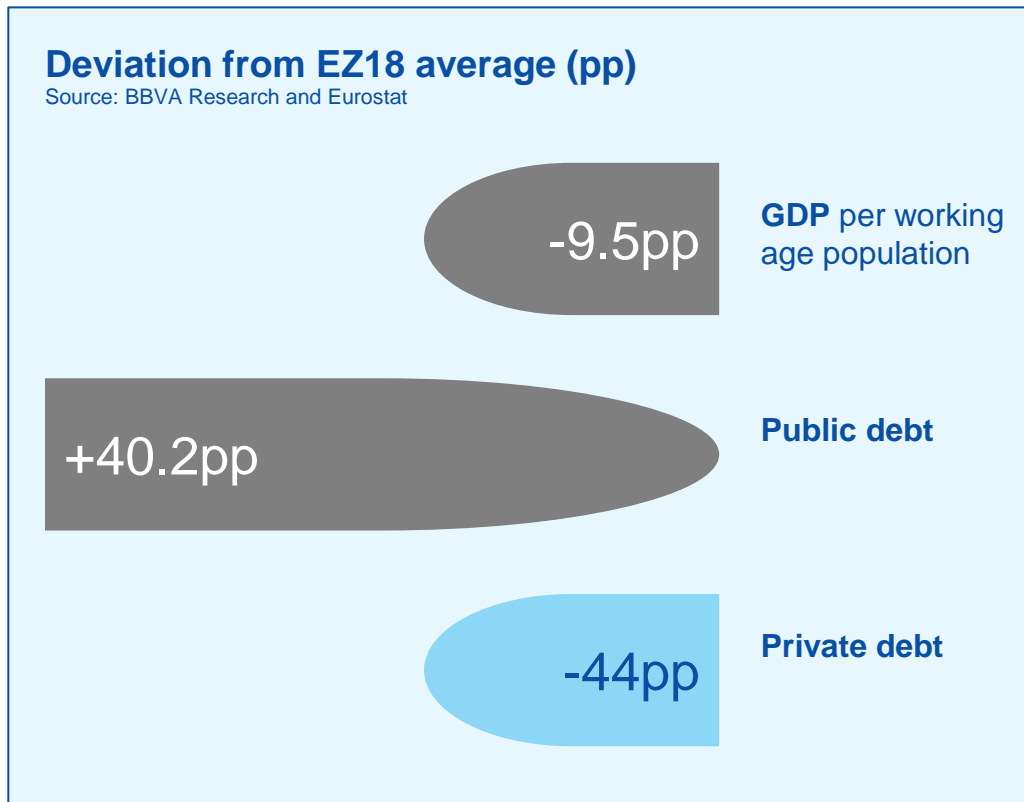
Source: Eurostat and BBVA Research

We continue to expect a slow recovery in 2015 (0.7%), driven by exports and investment

Investment will continue to improve as reforms aimed at improving the business environment are implemented

The declaration of unconstitutionality of cost-cutting measures can slow fiscal adjustment

Italy: reforms are needed to increase the growth potential



Income has deteriorated sharply in the past two decades and getting worse

A slow privatization program is delaying debt reduction (132.1% of GDP in 2014)

The private sector has been able to correct the high debt imbalance more rapidly

Spain: upward growth revision in 2015

| | 2013 | 2014 | 2015 (f) | 2016 (f) |
|--------------------------------------|-------------|-------------|------------|------------|
| Activity | | | | |
| Real GDP (%YoY) | -1.2 | 1.4 | 3.2 | 2.7 |
| Private consumption | -2.3 | 2.4 | 3.3 | 2.5 |
| Public consumption | -2.9 | 0.1 | 1.3 | 0.6 |
| Investment | -3.8 | 3.4 | 5.2 | 5.8 |
| <i>Domestic demand (contr. %)</i> | -2.7 | 2.2 | 3.0 | 2.7 |
| Exports | 4.3 | 4.2 | 4.7 | 7.1 |
| Imports | -0.5 | 7.6 | 4.5 | 7.5 |
| <i>Net exports (contr. %)</i> | 1.4 | -0.8 | 0.1 | 0.0 |
| External sector | | | | |
| Current account bal. (% GDP) | 1.4 | 0.8 | 1.3 | 1.4 |
| Public finances | | | | |
| General Govt. balance (% GDP) | -6.3 | -5.7 | -4.5 | -3.0 |
| Prices | | | | |
| HCPI, % average | 1.4 | -0.2 | -0.2 | 1.3 |

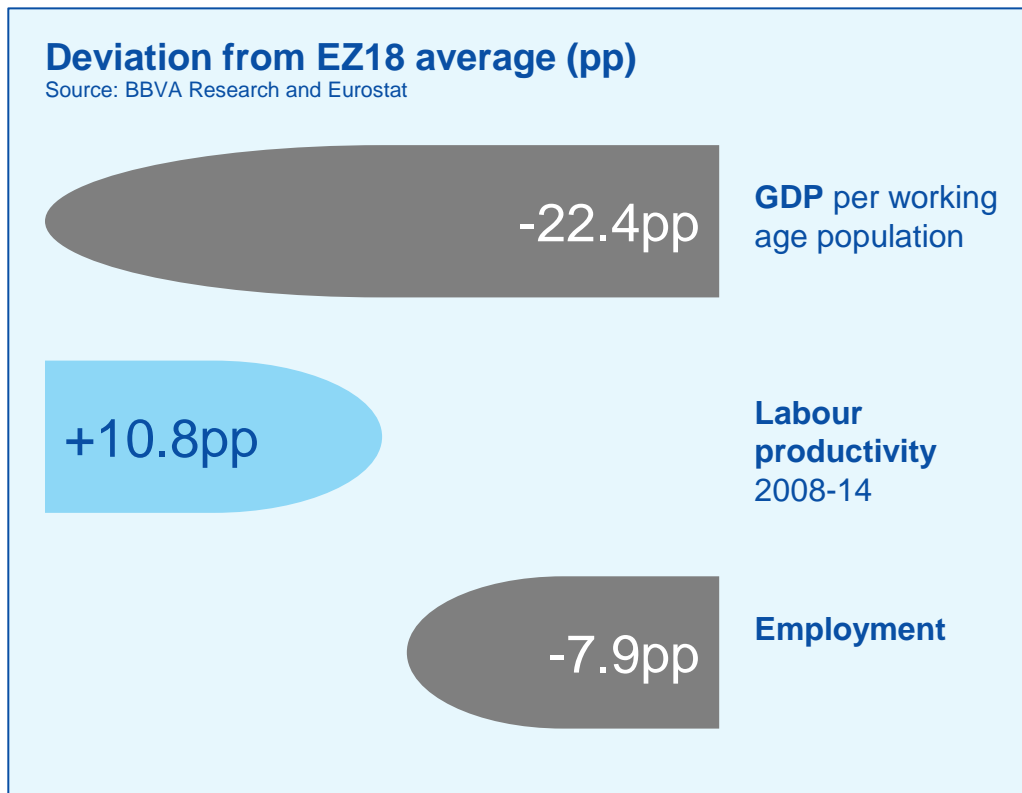
Source: Eurostat and BBVA Research

Both in 2015 and in 2016, activity will grow significantly, supported by domestic factors

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

The contribution of net exports to growth will be negligible

Spain: the labour market is improving, but challenges remain



Incomes are still well below the average for the eurozone

Most of the gains in labour productivity due to job losses

But 1,000,000 jobs will be created in 2015-16

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