RESEARCH

Economic Outlook

Europe

May 2011
Economic Analysis

- **The global economy continues to support eurozone growth,** but domestic demand is becoming increasingly important.
- **Strong increase in commodity prices has resulted in an acceleration of inflation. This has triggered an earlier than expected start of interest rate hikes,** but normalization of monetary policy will proceed slowly.
- **Financial tensions in peripheral Europe remain high, given the lack of decisive action to deal with solvency concerns.** Spillovers to economic activity outside the periphery have been limited.
- **The economic recovery will go on at a moderate pace,** with continued but less acute differences across countries.

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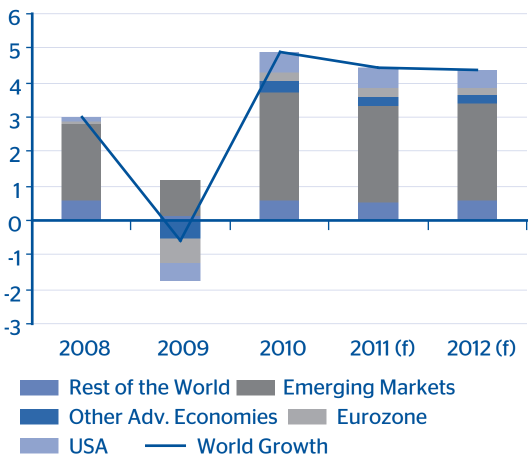
Closing date: May 25, 2011

1. Growth drivers: Momentum in core countries is compensating for the crisis in the periphery

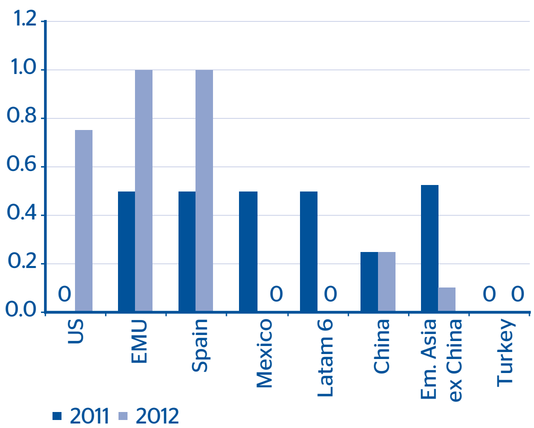
The recovery on the eurozone as a whole has continued in the first months of 2011, confirming that the deceleration of the last quarter of 2010 was due to temporary factors. The main driver of growth continues to be the external sector, which is supporting the demand of goods produced in core countries, especially Germany, and more than compensating for the continued turbulence in the periphery. The latter is not having a significant impact outside those countries, since they only account for a small share of the eurozone GDP. The evidence is even pointing to some strengthening of domestic demand in core countries. However, the prospects for the coming quarters are of a more moderate growth rates, as the main positive driver (strong global demand) will be confronted with other moderating forces, such as the need for fiscal consolidation in many eurozone member states, the impact of high oil prices on activity and inflation, and the pace at which the ECB will start raising interest rates. Although the latter will probably take place at a slow pace, given the knock on effects that it could have on periphery countries. In this sense, the lack of a permanent solution to the sovereign crisis continues to be a problem and poses a risk for the area as a whole. In the following paragraphs we examine these drivers in turn.

Chart 1
Global GDP growth and contributions (%)



Source: BBVA Research

Chart 2
Changes in year-end expected official interest rates relative to February 2011 forecasts



Source: BBVA Research

The global economy continues to grow strongly, supporting eurozone economic growth

The global economy continues to grow at a robust pace, and it is still expected to expand 4.4% both in 2011 and 2012 (Chart 1), supported primarily by emerging economies. However, the threat coming from high commodity prices (especially oil) increases the uncertainty and introduces a risk to growth and inflation in most regions, even to some of those that might benefit directly from high commodity export prices. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even though we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although going forward, they will probably be more of a concern in South America than in Asia, given tailwinds from commodity prices.

Financial tensions in peripheral Europe remain high, given the lack of decisive action to deal with solvency concerns, but spillovers from financial strains to economic activity have been limited so far

In Europe, the agreements reached during the March summits are useful in the medium term, both with regards to economic reforms and to help prevent future crises (Box 1). In addition, the changes introduced to the EFSF/ESM are positive in order to address liquidity concerns. However, financial market tensions in the three peripheral countries with international support (Greece, Ireland and Portugal) will continue as long as doubts persist about their solvency, and thus the risk of debt restructurings that include private investors. These lingering doubts will continue hindering funding to these economies and sustaining high sovereign yields, as well as could spread to other countries, even those with high solvency credentials. Thus, a comprehensive approach to debt resolution in case of insolvency is urgently needed, but one that takes into account that undergoing a hard debt restructuring that includes haircuts to private investors has a very high risk of contagion to the rest of Europe. In that case, it will have to be designed very carefully.

Commitment to fiscal consolidation has been unavoidable, but has put downward pressure on the periphery

Fiscal consolidation has put downward pressure on domestic activity in periphery countries that have been forced by market pressure to implement extraordinary consolidation measures during 2010. The structural adjustment in Greece, Ireland, Portugal and Spain has been sizable, to different degrees, and will continue to be so in 2011 and 2012. In Germany, France and Italy, the extent of fiscal restraint has been smaller, partly because they had lower deficits as a starting point, and partly because they had decided to back-load the adjustment to this year. In the case of Germany, the soar of revenues due to a much stronger activity than expected implies that the need of adjustment is smaller. Overall, fiscal consolidation will play an important role in the periphery, but less so in the core of Europe.

High oil and other commodity prices represent a global risk, but their impact should be easily absorbed without denting much global growth

A clear global risk stems from the rise in oil prices, caused, since the beginning of the year, mostly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will slowly, but gradually, be reduced, given still ample OPEC spare production capacity and OECD inventories, both above historical means. Nonetheless, oil prices could remain high at around 110-120 dollars per barrel during most of 2011, then slowly easing down to around 100 dollars in 2012. In addition, we think that the recent hike in oil prices may be thought of as precautionary demand shock and not just a supply-side shock, because we are observing a sharp increase in crude oil prices not accompanied by a fall in supplied quantities, since most lost production in Libya has been covered by other OPEC producers. As a consequence, the impact of such shock should be moderate on both activity and inflation (Box 2).

The strong increase in commodity prices, especially in Brent oil, has resulted in a strong acceleration of consumer inflation, triggering an earlier normalization of monetary policy than initially anticipated

Both the robust economic recovery in the first quarter of 2011 and the rise in core inflation in April for the second month in a row (see below) give ammunition to the ECB to carry out the normalization of its monetary policy. We continue to expect an interest rate hike (+25bp) at the next meeting in July. Despite this, we think that monetary policy normalization should proceed relatively slowly, and thus the monetary stance will remain accommodative (Box 3).

Differences in monetary policy stance across economic areas are leading to a more appreciated euro that could also adversely affect foreign demand

Worldwide, higher inflation in most economies in 2011 and 2012 will prompt monetary authorities to bring forward, and in some cases push for, more aggressive paths of interest rate increases. Nevertheless, there is still a wide heterogeneity in central bank approaches to the risks stemming from high oil and other commodity prices. In particular, in the US and euro zone, central banks are shifting –at different degrees– their focus from supporting growth or preventing a tail risk scenario of very low growth and deflation, toward maintaining inflation expectations anchored, particularly considering that the monetary policy stance is very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of earlier hikes. The ECB hawkish approach is to avoid any risk by being pre-emptive (and thus its first hike in April), and is not willing to look through the current oil price related rise in inflation (Box 2). On the other hand, the Fed, focusing more on the lack of sustainability in the recovery, prefers to wait and act only if risks materialise. As a result, the euro exchange rate against dollar should remain clearly appreciated in the medium-run with respect its equilibrium.

Box 1: The March EU Council summits have achieved progress, but solvency concerns for the current crisis have not been addressed properly

During the first months of 2011, financial market tensions in peripheral countries have remained elevated (Chart 3).

Spreads fell during January as markets felt that European authorities (and Germany in particular) were ready to design a permanent governance system.

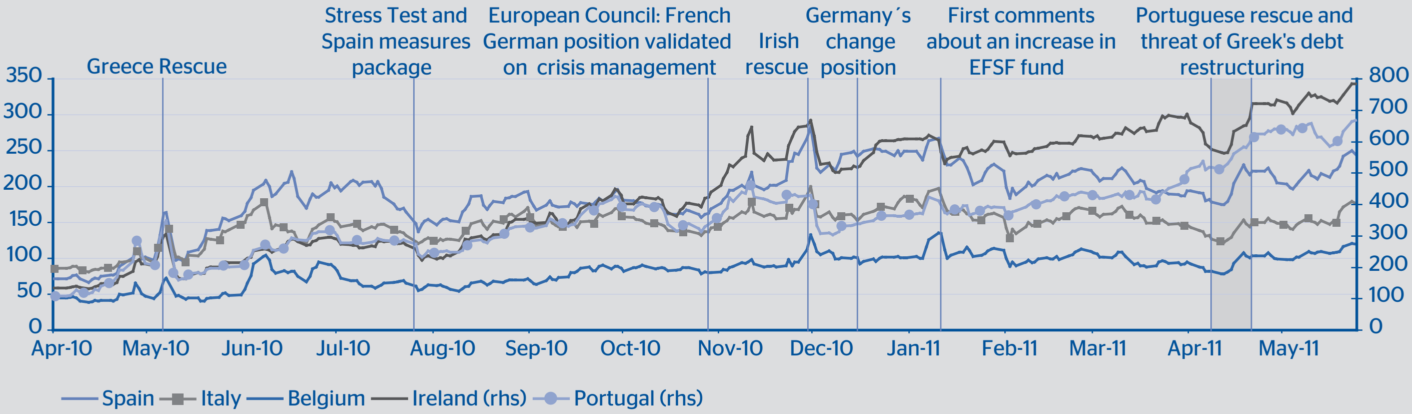
However, tensions mounted again after February, as it was clear that private restructuring of sovereign debt in Greece remained an option considered by EU authorities. After the intervention in Portugal and the March EU Council summits, these doubts have not been dissipated, as the results of these summits were not satisfactory in addressing the current concerns on the solvency of Greece and other eurozone countries.

Having said this, the results of European Council meetings held in March was satisfactory in several other aspects. They provided a good outline of future European governance on issues of economic coordination and crisis prevention.

- On the one hand, the Euro Plus pact (originally proposed by Germany) forces countries to submit each year structural reform programs in areas such as pensions, wage bargaining and fiscal rules. This is far from what Germany initially required (like, for instance, fiscal rules inserted in national constitutions) and lack of action will not be subject to sanctions, but it will add to peer pressure by eurozone countries on national reforms. The Pact has also served to have Germany agree to other decisions dealing with sovereign concerns.
- A second element, which was not particularly discussed in March, but nonetheless goes ahead, is the reform of the Stability and Growth Pact (SGP), which will bring forward the review of national fiscal policies, including the control of private sector imbalances, and strengthen penalties for defaulting countries. Certainly, this is a positive reform to prevent similar crises in the future, although leaving out political discretion in the application of sanctions and making them fully automatic would have been a better outcome. In particular, the ultimate application of sanctions will be voted by the EU Council and could be reversed by qualified majority. In our view the key element of the reform is the attention put to private imbalances, which, except in the Greek case, have been the underlying cause of the current crisis.
- The third piece is the reform of the European Financial Stability Facility (EFSF) and the European Stabilization Mechanism (ESM). Countries have committed themselves to increasing the effective lending capacity of the EFSF to an effective amount of 450 bn euros and to making the ESM permanent in June 2013. The latter also increased its effective capacity to €500bn. The new fund has been allowed to buy bonds in primary markets. This is certainly an improvement over the current framework and can help address sovereign liquidity problems. However, it fell short of expectations, given its the impossibility to purchase bonds in secondary markets, which would have facilitated voluntary debt restructurings similar to Brady bonds in the 90s and relieved the ECB from its current burden of supporting sovereign bond prices in times of high distress.

The main problem with the agreements is that they have not addressed solvency concerns in peripheral countries. The uncertainty surronding the sustainability of sovereign debt in some countries (most notably Greece) increases the probability that private investors will have to face losses on their bond holdings, even before the bail-in system is in place in 2013. In the communiqués after the summits, it is not at all clear that existing bonds cannot be subject to restructuring. Furthermore, from the beginning, EU and IMF funds have seniority over private debt. While these debt restructuring concerns continue, debt spreads will remain high in Greece, Portugal and Ireland.

Chart 3
10 year spread vs. Germany



Source: BBVA Research

Box 2: The effects of oil price hikes on activity and prices on the eurozone

In this Box, we seek to analyse the impact of oil price rises in both activity and inflation that underlie our new macroeconomic scenario.

Two preliminary considerations. First, we think that the present acceleration in oil prices reflects increased demand for precautionary purposes, derived from uncertainty regarding future supply in the face of geopolitical risks. This contrasts with supply shocks that are characterized by a reduction of supply that induces oil price hikes. The increase in petroleum prices was not the consequence of a fall in production, since most of the production loss from Libya has been covered by other OPEC members. Second, the causes that drive the present scarcity can be considered to be temporary. This implies that even if they can persist into 2011, their effect should be lower than that of a permanent change in the oil price levels.

In order to analyze the previous impact, we have estimated a structural VAR model with sign restrictions to identify the nature of these shocks (following the methodology of Uhlig, 2005[1]). The model includes, on one hand, three variables to identify shocks: the world oil production, the price of the Brent barrel and an indicator of world economic activity[2]. On the other hand, the model also includes GDP, CPI and official interest rate variables for both the eurozone and the United States. The estimations have been carried out with quarterly data since 1985 until the last quarter of 2010. Considering research by Peersman and Robays (2009)[3], we identify demand shocks for precautionary purpose as those whose response function in the VAR model shows i) an increase in oil prices, ii) an increase in oil quantities, but iii) a stagnation in global activity.

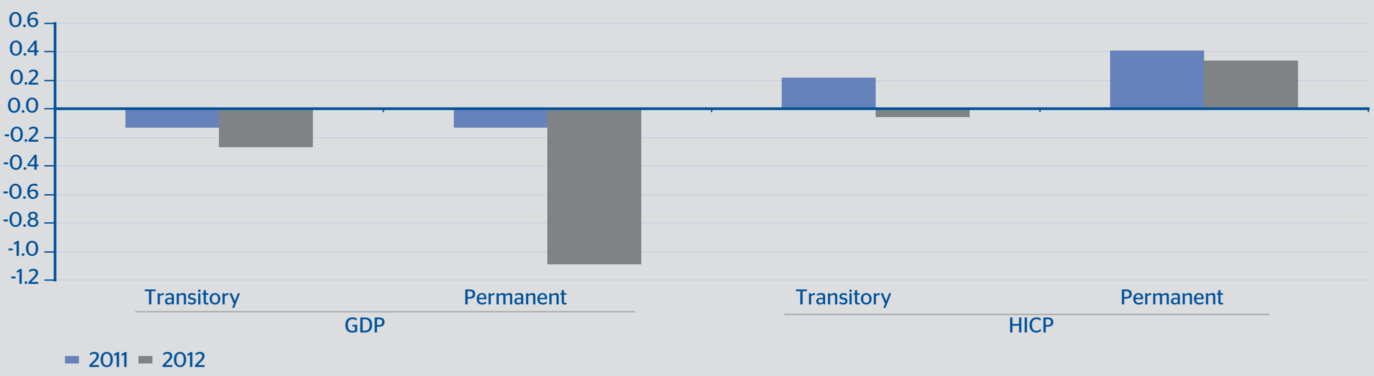
Once the shock has been identified, we have simulated different scenarios for the oil market. First, the oil shock assumption of our baseline scenario: a transitory shock in which Brent oil prices remain high at a level of approximately $120 per barrel throughout most of 2011, reverting to the $90-100 range in 2012.

The model's results (Chart 4) suggest a very limited effect from such shock on both activity and prices. Specifically, economic growth could be limited by approximately 0.1pp in 2011, with possibly a larger effect in 2012 (around -0.3pp). The effect on inflation would be felt much more rapidly, although also limited in 2011, driving inflation up by approximately 0.3pp. By 2012, the effect of oil prices on inflation would have disappeared. Data observed up to April 2011 are consistent with our results: activity has not been affected, although a measurable impact is expected for the second half of 2011 and next year. However, regarding inflation, observed data over the past two months point towards a stronger effect than expected by the model. This might be a consequence of greater indirect effects of the initial shock as domestic demand strengthens. As we analyzed in the previous February Europe Outlook, indirect effects of a similar magnitude than the ones observed would result in an effect of approximately 0.2pp in the first year, in addition to the effects caused by greater energy product prices in the HICP.

Second, we have also considered the impact that a permanent shock in oil prices would have over the economy. In particular, a permanent increase in the price of the barrel of Brent up to $140. In this case, a fall in GDP during the first year would not be much greater than in the case of a transitory shock, due to the lag with which it affects activity, but the impact in the second year would be much larger. There would also be a stronger persistence in the rise of inflation during the second year, not only because of the direct effect, but also as a response to greater translation of the increase in production costs to final consumer prices.

Overall, there are enough arguments that allow us to foresee a moderate impact from recent oil price hikes on activity in the eurozone. Due to greater temporary demand driven by precautionary reasons, it is to be expected that a contraction be significantly lower than the one resulting from a decline in oil supply. Nevertheless, the effects on headline inflation will be significant for most of this year, falling back quickly next year.

Chart 4
Oil shock impact the eurozone (pp)



Source: BBVA Research

1: Uhlig, Harald, 2005. "What are the effects of monetary policy on output? Results form an agnostic identification procedure", Journal of Monetary Economics, Elsevier, vol. 52(2).
2: Composite Leading Indicator for industrial production index for 35 countries from the OECD.
3: Peersman, Pert and Rbays, Ine Van, 2009. "Cross-Country Differences in the Effects of Oil Shocks".

Box 3: ECB: A slow rate hike cycle

Over the past few months the European Central Bank (ECB) gradually adapted its wording to a context of "upside risks to inflation", stressing its emphasis on the "separation principle" between monetary policy and non-standard measures. By doing that, the ECB gained enough flexibility to act on medium-term upside risks to inflation. In its March meeting the ECB signalled that it was ready to pre-emptively hike rates starting in April, when it raised rates (+25bp to 1.25%). April's move marks the beginning of an unusual rate hike cycle. Since then, the ECB has retained a hawkish tone that nevertheless has not been stressed further.

Sovereign related headwinds still linger and thus, this rate normalization cycle will be different. In our view, the ECB will be careful and move rates very slowly. The ECB will aim at striking the right balance between pre-emptive hikes –to fight risks of second-round effects and keep inflation expectations in check– and continued support to the financial system. Two major developments since its first pre-emptive move complicate this difficult task for the ECB: 1) upside risks to inflation have continued increasing, while 2) sovereign risks have rebounded as debt anxiety is spreading again to core-peripherals.

These two elements will likely condition the ECB's decisions. A favourable evolution in the sovereign crisis would allow the ECB to focus fully on its inflation mandate and move rates more rapidly. However, that seems unlikely, and less so than a few months ago, as Greek debt "reprofiling" risks, with the potential contagion effects to other peripherals –including core peripherals (Italy, Spain, and Belgium) that had decoupled until recently–have clearly increased.

When will the next step be taken? May's statement did not hint for a June hike. However, there was a slight wording change that might be relevant. By referring to monetary policy conditions as being "still accommodative" (as opposed to "accommodative" in the previous statement), it possibly set the ground for wording changes in June –when the new projections for 2011 HICP inflation will most likely be revised significantly upwards– to signal a 25bp interest rate increase at the following policy meeting. We continue therefore to expect a second move in July. Moreover, considering ECB's proactive approach –it is clear that they do not want to take any risks on the slight chance of second-round effects– our bias is still that the ECB might bring forward one of our expected hikes for early 2012 (in January and April), taking official rates to 1.75% by yearend.

What is the role of the peripheral debt crisis? It is clear that the ECB is now focused on inflation, but is still keeping an eye on liquidity and the dysfunctional performance of some market segments. The ECB is likely to proceed somewhat less aggressively on rate hikes than in the past –i.e. not following a path consistent with a reaction function–. In its previous tightening cycles, the ECB raised its key rate several times by 25 basis points every two months or so. Our bias is for +25 bp rate hikes for the third and fourth quarters, and an additional one in early 2012 that would take ECB interest rate to 2.0% (Chart 5). Then, the ECB might decide to pause –adopting a wait-and-see approach– until uncertainties –both in terms of the economic cycle and of the weaknesses of the financial system– fade away, possibly until 2013 when they would embark in a rate normalization process.

With regards to non-standard measures, although the ECB continues describing the SMP program as "ongoing", bond purchases have halted. Furthermore, as opposition to the possibility of Greek debt "reprofiling" outside the ECB seems to be gradually decreasing, it is unlikely that they would resume purchases even in the actual context of a worrisome rebound in peripheral risks. In contrast, concerning liquidity issues, it seems likely that the ECB would be forced by market conditions to delay once again the resumption of its "exit strategy".

Over the last quarter, the ECB did not change its non-standard measures regarding liquidity provision. In the three council meetings since our previous publication, there were two important developments: 1) In the March meeting, when the ECB decided to extend the liquidity provision to the financial system (full allotment tender operations "for as long as necessary and at least until July 2011"); and 2) it seems very likely that the ECB is creating a measure to wean to addicted banks off of central bank liquidity. In contrast, concerning sovereign purchases, the ECB reduced significantly its purchase pace since February, even with risks strongly rebounding as previously mentioned.

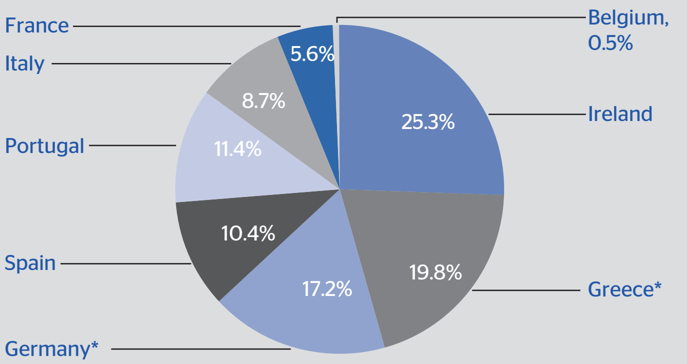
On the topic of the "new liquidity facility" to replace the Emergency liquidity facility (ELA), nothing has been announced yet, but what is clear is that the ECB wants to end the problem of addicted banks. The new liquidity program should be flexible and it may be a medium-term funding solution aimed at dealing with the liquidity needs of addicted banks to replace the ELA. The facility would be available across the eurozone and would be applied on a case-by-case basis. The program is likely to have no fixed time frame and will come under the control of the ECB's governing council. The change from ELA to the new facility implies that the ECB would assume further credit risks accepting lower rated collateral. In this regard, the ECB is likely to impose some conditionality on the banks, but not too strong, as the criteria for participating in the open market operations (OMOs) are relatively loose, so the ECB might not want to be too prescriptive for the new facility either.

This new liquidity facility could lead to a change in the ECB's exit strategy for liquidity measures as long as the most dependent financial systems on the ECB funding reduce their reliance on it. But with a high dependence of peripheral banks to ECB financing –with the banking systems of Greece, Portugal and Ireland representing close to 9% of the total banking system in the euro area (by assets) but accounting for around 50% of ECB borrowing (Chart 6)-, and with sovereign risks rebounding once again –and thus, delaying a return to market financing–, it is very likely that the ECB will extend auctions with full allotment at its June meeting, delaying both the resumption of its "exit strategy" and the new facility's announcement.

Chart 5
ECB Official Interest Rate

Source: ECB and BBVA Research

Chart 6
ECB: use of Central Bank Main and Longer-term Refinancing Operations (% by country)



* April 2011 = March data
Source: Central Banks, Datastream and BBVA Research

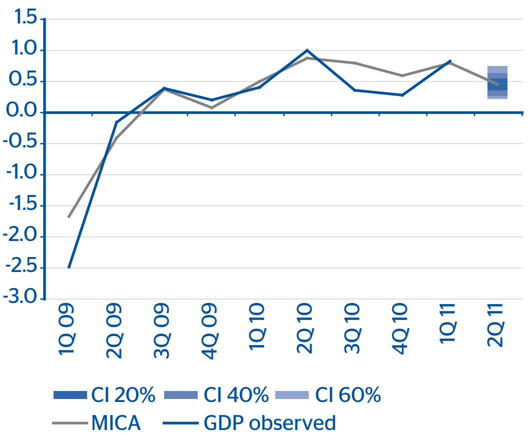
2. Recent trends and projections

2.1. Eurozone: Steady growth in 2011 and 2012

The recovery in the eurozone gained momentum in the first quarter of 2011, after growing modestly in the second half of 2010

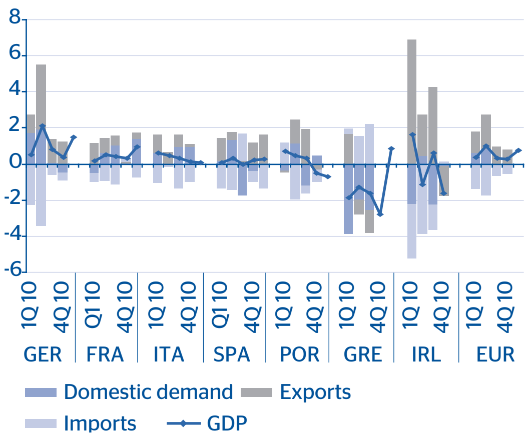
The flash estimate of economic growth in the eurozone for Q1 2011, at 0.8% q/q, not only confirms that economy has recovered from a temporary blip, but it has also exceeded expectations. These are positive figures, considering the high levels of uncertainty that still persist in the eurozone as a whole. Still, the recovery continues to be two-speed, or multi-speed, led by Germany and France. Different speeds are mostly determined by the evolution of domestic demand, which lags behind in peripheral countries, as fiscal consolidation efforts intensify and de-leveraging continues. In spite of the upward surprise to our forecast (which was 0.64% q/q), we continue to expect a slowdown in the recovery in coming quarters. This is indeed reflected in more moderate soft indicators published so far for the second quarter, i.e. PMI indicators and the EU confidence survey. Both surveys also show that divergence between the core and the periphery of the eurozone persists, something also observed in our divergence indicators (Chart 7).

Chart 7
Eurozone:
GDP growth and MICA model forecast (% q/q)



Source: BBVA Research

Chart 8
Quarterly GDP growth and contributions



Source: BBVA Research

Foreign demand remains the main driver of economic growth in the eurozone as a whole, especially in the periphery

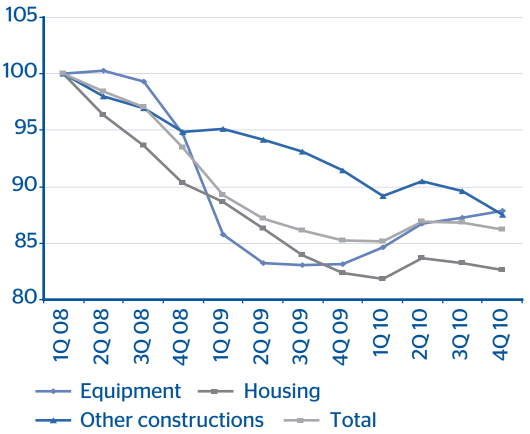
Export dynamics in the eurozone continue to benefit from continued and robust external demand growth coming from emerging economies. This particularly applies to equipment capital goods that drove investment, especially in Germany. After exports growth slowed in the last months of 2010, when they exceeded pre-crisis levels, trade balance data showed some renewed strength in the first quarter of this year. Nevertheless, these data also present higher import growth, roughly in line with the acceleration of domestic demand. As a result, net exports' contribution to growth may have shrunk compared to the one shown in the initial phases of the recovery. We expect this pattern to continue throughout the forecast horizon. In any case, given the differences across countries in the evolution of domestic demand, and therefore imports, peripheral economies should continue to see net exports as the main driver of growth (Chart 8).

Private consumption resilient, but without clear signs of decisive recovery

Private consumption was more resilient than anticipated at the end of 2010, supported by improved consumers' expectations on the economic recovery and better labour market performance. This reflects the decline of savings, especially for precautionary reasons, in a context relatively low household leverage for the eurozone as a whole. However, households' disposable income has been undermined by the rise in inflation, and is thus weighing on the pace of consumption recovery.

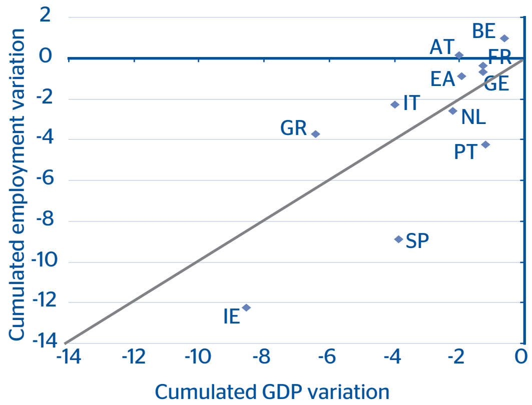
Detailed breakdown of economic growth in Q1 is not available yet, but short-term indicators point to a subdued, although still resilient, private consumption at the beginning of the year. Again, the divergence across member states is apparent, with consumption remaining very weak or even contracting in the periphery, hampered by tough fiscal adjustment plans combined with the need to adjust private sector imbalances and the strong deterioration in labour markets.

Chart 9
Eurozone: Investment by components (Index, 1Q2008=100)



Source: Eurostat and BBVA Research

Chart 10
Employment and activity (Cumulated variation 2008-2010)



Source: Eurostat and BBVA Research

The adjustment of construction combined with public spending cuts continue hampering the recovery of investment

Since the beginning of the recovery a clear dichotomy between the evolution of investment in equipment and the construction sector has been apparent (Chart 9). While the former has clearly benefited from strong external demand in more competitive countries, the construction industry continues undergoing a major process of adjustment, as public investment in infrastructure suffers from spending cuts. However, much of this adjustment has already taken place. Investment rates in both housing and other construction have already cumulated falls of around -17% and -13%, respectively, since the beginning of the recession, returning to its 2002 level. In recent quarters a moderation in the fall of construction investment has been observed (only interrupted in the last quarter of 2010 as a result of harsh weather conditions), while the index of industrial production for the construction sector up to February shows a rebound in activity at the beginning of the year.

At the aggregate level, investment should have reached its minimum during 2010, while capacity utilization has already reverted to its long-term average levels. With interest rates still low, in spite of the expected normalization of monetary policy, and profits growing, investment should recover during 2011.

Job creation is still incipient, and not enough to induce a clear downward trend in the unemployment rate

Growth has been able to stop the strong employment destruction that has taken place since the beginning of the recession, but not to generate significant job growth. Employment increased slightly in Q2 2010, only to remain stagnated in the second half of the year, which resulted in an overall fall in employment for the year as a whole. In cumulative terms, employment has grown 0.4% since the beginning of the recovery, after a cumulated fall of -2.6% that occurred during the crisis. Once again, the data also hides significant inequalities among the countries. Job destruction continues in periphery countries, while core countries also exhibit different trends within themselves (Chart 10).

The weak job creation has only translated into a stabilization of the unemployment rate since the beginning of the recovery. The cyclical peak of unemployment was probably reached in the last quarter of 2010, with expectations of a slight reduction at the beginning of 2011, although we do not expect a substantial decline in the short term. Confidence surveys support this view, by showing a moderate rise in hiring intentions in the beginning of the year. This stabilization has been generalized across countries, although in some cases it has been underpinned by the increase in the economically active population.

Forecasts for 2011 and 2012: Ongoing economic recovery at a moderate pace

For 2011, we continue to see a slowdown in economic activity. The strong acceleration observed in Q1 should have been temporary (after the negative impact of the harsh winter at the end of 2010), especially in construction sector. Exports will remain a key driver for sustainable recovery, as supported by robust global demand, while domestic spending should be taking over from net exports, albeit gradually and moderately. In short, economic growth in 2011 would be similar to that printed in 2010, remaining slightly above eurozone potential growth.

For 2012, GDP growth will decelerate somewhat as a result of the limited impact of high oil prices. In addition to direct effect on output, they will also adversely affect activity throughout their impact on inflation and interest rates, affecting both consumption and private investment, as well as on the euro exchange rate. All this at a very limited magnitude. Furthermore, those factors determining a slower recovery pace than in previous cycles persist, as de-leveraging in both public and private sectors will continue, as well as the uncertainty in the banking system resulting from the financial and sovereign crisis.

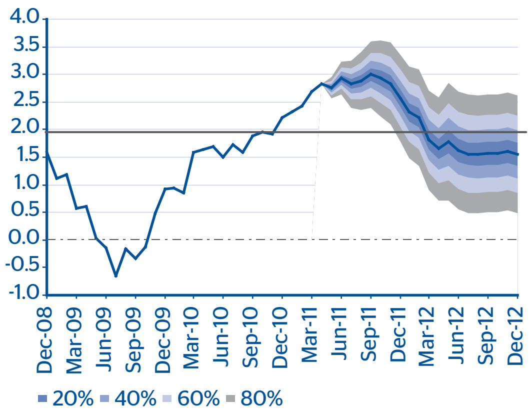
Overall, our scenario remains unchanged for 2011 at 1.7%, while it is slightly revised downwards in 2012 to 1.5%. The details of these revisions are the following: i) the base effect resulting from a stronger economic momentum in Q1 2011 than anticipated three months ago (with an impact on GDP of +0.1pp in 2011), ii) higher oil brent prices than initially expected (-0.1pp in 2011 and -0.2pp in 2012), iii) an earlier normalization of monetary policy (-0.1pp in 2011 and -0.1pp in 2012), and thus iv) a more appreciated euro exchange rate than in the previous scenario (-0.1pp in 2012). (Chart 11)

Across member states the picture will continue to differ in 2011 as a result of disparate performance of domestic demand. In 2012, divergence is expected to diminish, resulting from lower growth in core countries - that will revert towards their potential growth - and faster growth in peripherals, given that most of the fiscal adjustment has been focused in 2010 and 2011.

Chart 11
Eurozone: GDP growth (Annual average growth, %)

Source: BBVA Research

Chart 12
Eurozone: HICP (% y/y)



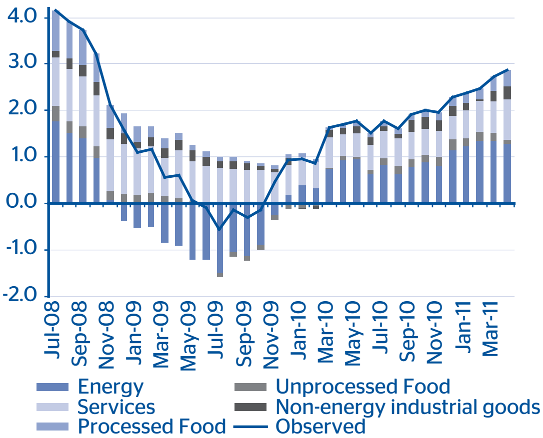
Source: Eurostat and BBVA Research

Regarding the labour market, employment is expected to increase timidly in 2011, around 0.5%, as firms are likely to remain cautious in hiring until concerns about the pace of the recovery are dispelled, accelerating somewhat over 2012. As a result, we continue to expect a slow downward trend in unemployment rate in the forecast horizon, declining to around 9% in 2012, still so far from the pre-crisis levels.

Inflation accelerated rapidly in the first quarter as a consequence of the strong increase in commodity prices. Indirect effects were larger than expected, but there are no signs of second round effects

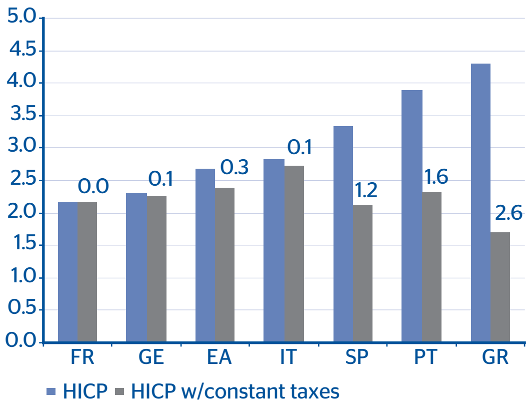
Annualized inflation continued to accelerate in the first quarter of 2011, responding to pressures from commodity prices (Chart 13). Direct effects from higher Brent prices brought about a strong upturn in energy inflation (+0.37pp in Q1), which explains most of the rise in the headline index (+0.45pp), while core inflation was much more moderate (around +0.1pp). Part of the increase in the core component also resulted from higher commodity prices, both from higher food prices, which pushed processed food inflation (+0.1pp), and from indirect effects from increased production costs. This brought about higher service prices (+0.1pp), especially in transport services and holiday packages. Finally, the moderation in non-energy industrial goods, as a consequence of winter sales, ended up partially offsetting the climb of the core component. This acceleration in recent months came as a slight upwards surprise to our projections both in the headline and in the core component.

Chart 13
Eurozone- Annual HICP inflation rate: Contribution by components (pp)



Source: Eurostat and BBVA Research

Chart 14
HICP by countries (% y/y, values are differences in pp between rates)



Source: Eurostat

Across member states, the acceleration shown in both headline and core inflation was widespread. The greatest increase in core prices in April was recorded in Germany. Fears of second round effects affect core countries especially (France and Germany), where the recovery has been robust and the labour market has shown clearer signs of improvement. However, there are no apparent signs of second round effects, since wage rises continue to be moderate. In peripheral countries, higher inflation was mainly a result of tax increases on consumption. If we discount these effects, the acceleration of inflation was more moderate (Chart 14).

We think that headline inflation will probably increase slightly in coming months to annual rates close to 3%, moderating afterwards, in the last quarter of 2011 (Chart 12). As a result, the average annual inflation rate would stand well above the ECB's inflation target, at around 2.7% in 2011. The expected moderation at the end of the year should largely respond to a moderation of energy prices, while core inflation should remain relatively stable at rates close to 2% y/y. As a result, core inflation is projected at 1.7% in 2011. For 2012, we continue to see headline inflation reverting to rates below 2%, driven by lower commodity prices together with a more appreciated euro, while a large base effect in annual rates is also expected, resulting in a slight deceleration in core inflation.

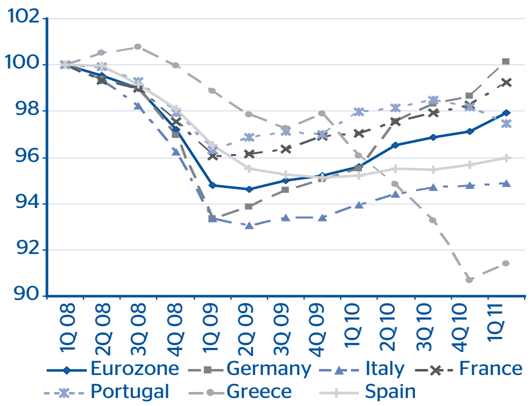
Risks to economic growth broadly balanced in 2011, but tilted on the downside in 2012. Inflation risks are on the upside

Downside risks on activity are linked to an unsatisfactory evolution of the crisis in the periphery, possibly triggered by bad results from the bank stress tests to be published in June, or worse than expected fiscal consolidation outcomes in smaller countries. A deterioration of the geopolitical situation in MENA countries would also be a source of risk. All these are more likely to materialize in 2012 than 2011. On the upside, the recovery of domestic demand in the core of Europe could be stronger and more protracted than expected, leading GDP to growth rates more in line with previous cycles.

On inflation, the upward risks derive from possibly higher commodity prices, both from energy and food, and, to a lesser extent, more apparent second round effects to core inflation in 2012. On the downside, a persistent strength of the euro would weigh down on inflation.

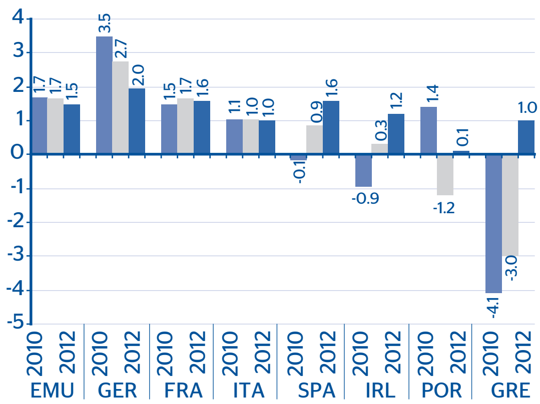
2.2. Member States: A closer view

Chart 15
GDP (Index, 1Q2008=100)



Source: Eurostat and BBVA Research

Chart 16
GDP growth by countries



Source: Eurostat and BBVA Research

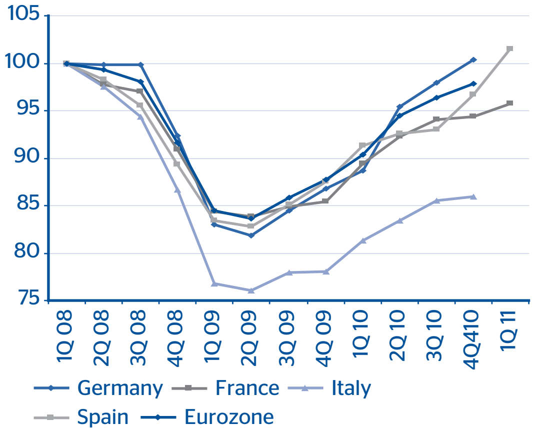
Germany: Recovery remains robust, building up sound fundamentals for a more broad-based growth

The German economy rebounded strongly after the recession, benefiting from robust global demand for investment goods, especially from emerging economies. This also triggered sound fundamentals to support greater dynamism of domestic demand that ended up becoming the main driver of growth in 2010. On the one hand, investment surged as many investment plans that were postponed during the crisis were implemented, while capacity utilization has quickly reverted to the historical average, all supported by the need to meet a strong foreign demand. On the other hand, labour market conditions continued to improve over last year as a result of both the short-term scheme to fight unemployment and past structural reforms, which, combined with a private sector without major leverage problems, drove an incipient recovery in private consumption. Finally, unlike other member estates, the maintenance of fiscal stimulus also supported growth.

The good results of the first quarter have partly reflected a rebound from the weather-related slowing at the end of 2010, especially, in construction investment. Still, soft data available for Q2 showed that this strong economic momentum is unlikely to remain in coming quarters, as high commodity prices, interest rate hikes, and still high uncertainty about financial problems in the periphery weigh somewhat on economic prospects in coming quarters. As a result, the German economy will grow again above the eurozone average, somewhat below 3%, but with a lower positive gap than the one observed in 2010. The growth pattern should shift further towards domestic demand. Although exports will continue to benefit from a robust demand from emerging economies, it is expected that the contribution of net exports declines as a result of greater dynamism in imports. For 2012, we see growth slowing again in a process of convergence towards its potential rate, mainly supported by domestic demand and a negligible contribution from net exports.

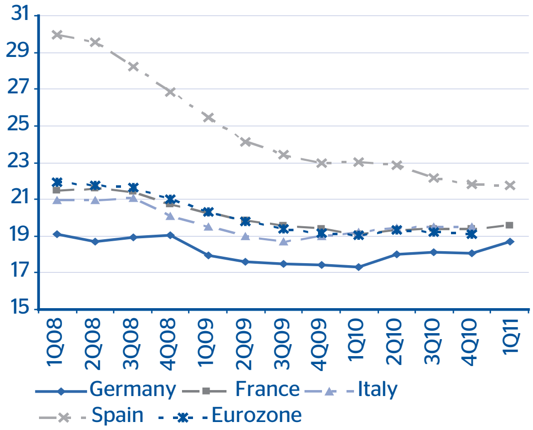
Regarding the evolution of prices, headline inflation accelerated rapidly in the last quarter of 2010 and the first quarter of 2011, driven by commodity prices. This acceleration was higher than expected, with inflation picking up around 1pp over the last six months. It was also slightly higher than that observed in the eurozone, as a result of a rebound in prices of core components. More worrying was April's inflation, which showed a sharp rise in core inflation, the largest recorded across member estates. Although this increase was mainly due to seasonal factors, it also points towards greater indirect effects from high commodity prices driven by the incipient strength of private consumption and rapidly increasing capacity utilization. April's figures raise fears of second-round effects in coming months. However we do not have much evidence of wage acceleration. There have been more requests of wage increases in several German sectors recently, but this also happened after the oil shock of early 2008. In the end, the rises agreed were moderate. Moreover, this year only 30% of the wages will be negotiated, the remaining being subject to last year's negotiation. Looking also at past episodes of oil price hikes (1990, 1998 and 2008), it is apparent that in Germany the evolution of wages fits more closely that of GDP, and not that of oil prices. In other words, all the evidence suggests that the risks of an inflation spiral following the oil prices shock are still far from us. Overall, we project that German inflation should end up averaging around 2.6% in 2011, similar to eurozone's average, slowing in 2012 to rates slightly below 2%.

Chart 17
Exports by country (Index, 1Q2008=100)



Source: Eurostat and BBVA Research

Chart 18
Nominal Investment as % nominal GDP



Source: Eurostat and BBVA Research

France: Moderate and balanced growth

French economic growth has accelerated in recent months, after growing at a rather stable pace since the start of the recovery. In particular, activity grew by 1% q/q in the first quarter, accelerating from 0.3% q/q in the last quarter of 2010, supported by domestic demand. The pattern of growth continued based on the resilience of private consumption and an investment surge, still benefiting from the final phase of the government's recovery plan. In addition, consumers' and managers' confidence remains relatively stable at the beginning of Q2, suggesting that domestic demand should continue to perform an important role in the sustainability of the recovery. This, however, should proceed at a slower pace, as the Q1 rebound was also supported by a short-lived effect from inventories rebuilding. In contrast to the German economy, the strength of external demand has been felt less, given the lower degree of openness of its economy, and the contribution of net exports was moderate in the early stages of the upswing and will continue to lose steam throughout the forecast horizon.

Recent data suggests that this growth pattern will continue in the future, with resilient private consumption, as improvement in labour market conditions should compensate the effects of higher inflation, fiscal consolidation and somewhat higher interest rates. Hence, we only expect a timid deceleration in the growth rate of private consumption. On the other hand, we expect faster investment growth, once capacity utilization reverts to historic levels. As a result, our forecasts point towards an increase in the contribution of domestic demand to economic growth in 2011. With regards to the external sector, the dynamism of exports should be compensated by a larger increase in imports, resulting in a negligible contribution to growth. In 2012, we expect the French economy to advance at a pace similar to this year.

Inflation in France has been much more stable than in the eurozone during the last few months, partly because of the lesser weight of energy products in the harmonised consumer index. Specifically, both headline and core inflation have increased about +0.3pp in the last six months, clearly below the annual average rate of the eurozone, where about half of the increase in the inflation rate has been explained by energy prices. The second most inflationary component is services. Our forecasts point to both headline and core indices remaining stable, or only increasing slightly, throughout the rest of the year. Inflation should be close to 2.3% y/y, below the eurozone average. Second-round effects are even less likely to occur in France, as the unemployment rate still remains 2pp above the one recorded before the crisis. At the same time, the new minimum wage framework that has brought salary indexation to an end should contribute to anchor global wage expectations.

Italy: Sluggish recovery continues

The Italian recovery lost momentum in the second half of last year, while advanced data has confirmed a subdued economy in the first quarter. This picture is underlied by a slowdown in exports, which were the driver in the early stages of the recovery, and translated to slower investment, especially in equipment. In addition, imports have increased at a faster pace to meet the needs of higher investment as well as rebuilding inventories, so that the contribution of net exports ended up being negative. Private consumption has also remained subdued so far, due to high unemployment and dwindling purchasing power resulting from rising inflation.

Looking forward, the Italian economy should grow by about 1% in 2011 and 2012, well below the eurozone average, as structural weaknesses continue to weigh on activity. Exports will benefit much less from the robust global demand, as they continue mainly oriented at other member states. Private consumption will continue to grow at a moderate pace, slightly more slowly than in 2010, driven by a marginal improvement in the labour market and a disposable income battered by inflation rebound. Behind the marginal improvement expected for the job market lies reabsorption of employees that benefited from the wage supplementation scheme, before hiring new workers. Investment is expected to slow slightly after the rebound observed in 2010, reflecting the still low levels of capacity utilization as well as firms need for de-leveraging.

Regarding price developments, headline inflation has also accelerated significantly since the last quarter of 2010, pushed by energy an inflation, as elsewhere. Core inflation also rose strongly in March, after having slowed in previous months, but the rally was mainly a response to the end of winter sales, as core inflation remained relatively stable in April. For 2011, we expect annual inflation to reach a similar rate to that averaged in the eurozone, slowing throughout 2012, as a result of the slowdown in the inflation of energy products after the price of Brent stabilizes. Despite possible risks of a new surge in oil prices, the Italian government has put a brake on second-round effects, as the wage negotiation framework only considers inflation excluding energy prices for wage increases.

Spain: Slow recovery, positive differentiation against rescued countries

Spanish GDP grew by 0.3% q/q at the beginning of the year, similar to what was observed in Q4 2010, but still not enough to create jobs. The growth pattern continued based on the strong momentum of external demand, while domestic demand remained weak. Looking forward, no abrupt changes are expected on the main sources of economic growth, although some new elements have arisen, tilting risks to the downside. First, public consumption will continue to contribute negatively to economic growth in the medium-run, given the strong commitment that the government is showing towards meeting fiscal targets. Second, upward pressures on inflation together with earlier than expected interest rate hikes, have joined still weak fundamentals supporting private domestic demand and the ongoing de-leveraging process to add an additional downward bias on the pace of the recovery in private expenditure. Nonetheless, the total negative effect of these new factors is expected to be moderate, and especially focused at the end of the forecast horizon. In contrast, the recent appreciation of the euro, as a consequence of tighter monetary policy in the eurozone, should not trigger a significant loss of competitiveness. Moreover, despite the occurrence of significant events in major economies (Japan's earthquake, Portugal's assistance program, uncertainty regarding Greece's solvency), the exports outlook is expected to remain favourable over the forecast horizon. Besides, and despite the persistence of financial strains in sovereign debt markets, there has been a positive differentiation of the Spanish economy against peripheral countries, as a result of compliance on aggregate of fiscal targets and thanks to actions taken to improve transparency in reporting public accounts. In addition, recent efforts made to accelerate the restructuring of part of the banking sector and the implementation of essential structural reforms (pension and labour market) have also contributed to lower both the spread and the uncertainty regarding Spanish economic prospects.

In short, our projection envisages shy economic growth in the short to medium term, with an average annual growth around 0.9% in 2011 that includes, for the first time since the beginning of the crisis, net job creation in the final stretch of the year. Economic growth in 2012 (1.6%) should bring net job creation on aggregate for the whole year, although the unemployment rate will not decline significantly.

Regarding prices, headline inflation picked up late in the first quarter to 3.6% y/y, mainly driven by a marked increased in oil and food prices, as 2.2pp are directly attributable to the energy and unprocessed food components of the CPI. Furthermore, indirect effects from rising commodity prices (pass-through from higher producer prices) were observed in processed food and holiday travels, contributing to headline inflation increase with around 0.5pp and 0.1pp, respectively. As a result, inflation in both services and non-energy industrial goods, excluding the above components affected by indirect effects, remained at subdued rates, contributing to headline inflation with 0.7pp and 0.2pp, respectively. Nevertheless, given the weakness of domestic demand and high unemployment rate, there is no clear evidence of second-round effects. On average, headline inflation is expected to remain below 3% in 2011 and to slowdown in 2012 to 1.3%.

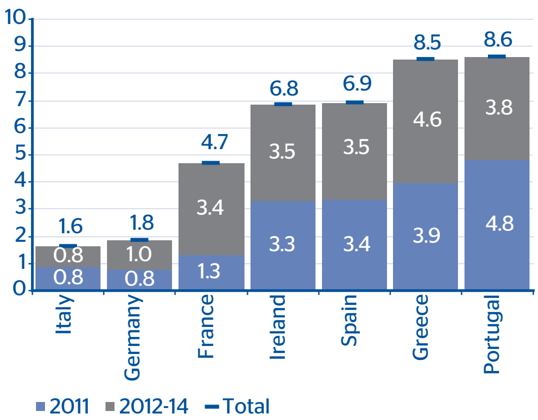
3. Fiscal outlook

Belt tightening is underway in all eurozone countries

The final figures for fiscal developments in 2010 within eurozone members leads to a mixed reading. While core economies performed according to plans and in some cases even better than expected, due to favourable cyclical outcomes, some peripherals have missed their targets and fiscal deficits been subject to upward revisions, partly because of revisions of historical data. Such was the case of Portugal and Greece. Tightening in core economies such as Germany, France and Italy benefited from the support of the economic recovery, but also by the gradual phasing out of the stimulus plans implemented since the beginning of 2009. In Spain the good performance of the budget at the central government level compensated the slippages at the regional and local levels.

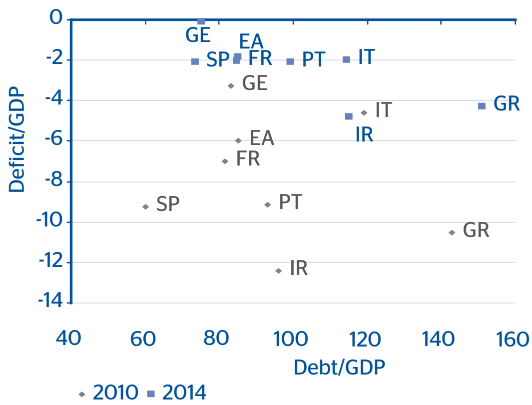
Prospects for 2011 remain positive, but challenging nevertheless, as the bulk of structural adjustment effort is concentrated in the current fiscal year. Portugal faces a tough adjustment this year, although the focus needs to remain on the structural reforms to bring back growth and raise potential GDP (Box 4). The focus in Ireland remains on resolving the troubled banking sector situation, but they need to take further action in cutting the excessive spending rate after the bust of housing bubble (Box 5). The fiscal situation in Greece is also a source of concern, as after a year from the announcement of the financial rescue and an important fiscal effort carried in 2010, there are signs of reform and fiscal fatigue and regarding the sustainability of Greek debt (Box 6). All in all, by 2014 all eurozone economies have targeted to return to deficits at around 3%, although debt levels will remain at still high rates.

Chart 19
Structural adjustment effort (in pp of GDP)



Source: BBVA Research based on SGPs and own calculations

Chart 20
Debt and deficits (% of GDP)



Source: European Commission and BBVA Research estimates

Germany: low deficit, but a sharp rise in gross debt as a consequence of aid pledged to financial institutions

Germany comfortably achieved 2010 targets, with a deficit of 3.3% against a projection 5.5%. Growth was well above expectations included in the budget, while the unemployment rate has performed much better than expected, translating into a favourable cyclical balance. However, debt increased by approximately 10 pp up to 83.2% of GDP as a consequence of the foundation of financial institutions to support the banking sector during the crisis. The Government plans to maintain the consolidation path and reduce the deficit so as to bring it to -2.5% this year and gradually reach a -0.5% by 2014. The reduction will be achieved through the phasing out of special measures to fight the crisis, the continued cyclical recovery, and the introduction of consolidation measures to meet the requirements of the constitutional budget rule, which requires a structural deficit of at most 0.35% of GDP after 2015. The structural adjustment expected for 2011 is of 1 pp of GDP, while debt is expected to start a downward profile so as to gradually achieve a 77.5% of GDP by 2014.

France: challenges remain ahead as deficit remains high and the details of much of the structural adjustment have still to be determined

With a 7% deficit, France improved on its 2010 target of 7.7% of GDP. Debt is estimated at 81.7% in 2010. It is expected to reach its maximum level at 86% by 2012, and to fall from then onwards. The structural adjustment in 2010 was moderate, of 0.6% of GDP, reflecting the phasing out of special measures, while changes, in the "professional tax" had the opposite effect. For 2011 the structural adjustment will be more aggressive, and is expected to reach a 1.3 pp of GDP. The measures projected include the elimination of tax allowances and further spending control by public administrations. For the period 2012-14 the structural adjustment is projected a 1.3 pp on average, though the details have still to be disclosed.

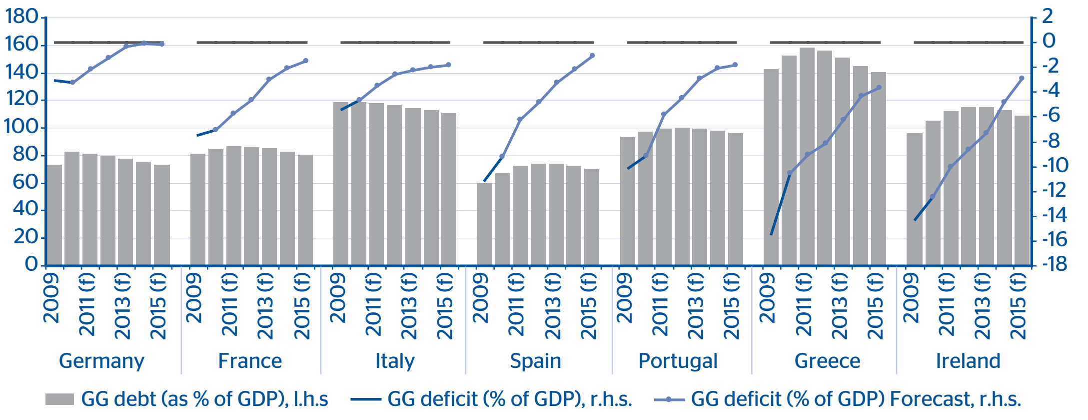
Italy: relatively low deficit but high public debt

The Italian general government printed a deficit at -4.6% of GDP in 2010, being one of the lowest of the eurozone, against a -5% target. However, the public debt reached 119% of GDP at end of 2010, the second highest in the eurozone. Public expenditure growth was contained by cutting capital spending and reducing the wage bill, while revenues were sustained thanks to the fight against tax evasion. For the years ahead fiscal consolidation will continue, as nominal wages are frozen in 2011 at 2010 levels and restrictions in recruitment have been imposed. Intermediate consumption will grow modestly and there will be strict limits of transfers to local and regional governments. Capital spending is expected to fall. Debt will reach, according to the Italian government estimates, 120% of GDP this year and start a slow downward trend from then onwards.

Spain: consolidation effort is titled towards spending and based on realist revenue forecast

Spain closed in 2010 with -9.2% deficit and a debt at 60.1% of GDP. The stability programme for 2011-14 and the National Programme for reforms have been approved by the government. The targets remained unchanged and for 2011 the government expects to reduce the deficit to a -6% of GDP in 2011 and to a -2% by 2014. The broad measures to meet the targets are tilted towards a reduction in spending (by 5.2 pp of GDP), while the increase of revenues will be smaller (1..9 pp). On the revenue side, part of the increase will come from economic activity together with the tax increases. On the expenditure side, the decline will come from wage reductions, replacement ratios, contention of public investment, and ordinary spending control. Some of these measures will have a persistent effect; however, specific details and the expected impact for 2012 onwards have not been disclosed. In spite of being an ambitious program, risks remain and are concentrated at the regional level (see our latest Spain Economic Outlook).

Chart 21
General Government debt and deficit (% GDP)



Note: Ireland deficit figures exclude NAMA
Source: National Stability Growth Programs and BBVA Research

Box 4: Portugal's rescue programme is broad-based, ambitious and focused on restoring growth

In April, Portugal became the latest eurozone country to seek a bailout from the EU/IMF. The Portuguese debt maturity calendar was challenging in the short-term, and finally it was the main trigger behind the government's decision to request financial aid. Portugal has agreed with the IMF-EC-ECB troika an aid package of €78bn EUR. Overall, the conditionality plan attached to the program is quite positive, as it is more loaded towards structural measures than to fiscal restraint. This is sensible, as the main problem of the Portuguese economy is its low growth potential and high current account deficit, rather than the sustainability of its public debt.

The deficit figure for 2010 has been revised twice in less than a month, first from a 7% to a 8.6%, and then to 9.1% (Chart 22). The first revision was due to the accounting of aid to a bank (BPN), while the second revision took into account the correct accounting of three public-private partnership projects to finance public investment. The fiscal leg of the plan targets a 3% deficit by 2013 instead of 2012, but the structural fiscal effort is similar to previous plans. This seems also reasonable, to avoid a risk of too deep recession (remember, for instance, that fiscal consolidation plans approved by the European Commission for other EU countries foresee hitting the 3% target for 2013 in most cases but even 2014 in others). Still, the bulk of the adjustment is done in 2011. The troika growth projections (-2% in 2011 and 2012) are relatively pessimistic, building a buffer for eventual bad news. Under our projections, the total structural adjustment is of 8% of GDP, instead of 10% - still a challenging figure. Fiscal consolidation for 2012 and 2013 is broad-based, and includes an important tax reform, which makes the tax system less distorting and more pro-competitiveness by rising indirect taxes and leaving a margin to lowering labour taxes. Privatization includes major public companies (Airports, GALP, REN, EDP, TAP, Post) and is relatively frontloaded. Public debt stands at 93% in 2010 (Chart 23), and is expected to surpass the 100% threshold by 2012, according to our baseline scenario that is less pessimistic than the one provided by the Government and the troika.

Structural reforms are addressed very comprehensively, which is key to revive the meagre growth potential. The labour market reforms are tough on employment protection (reducing firing costs very significantly and leaving them at the same level for all types of contracts) and unemployment benefits (reducing replacement rates and their duration). On wage bargaining, which should be key to restore competitiveness, they require that previous agreements among social agents be implemented. All these reforms will help reduce labour market duality and increase productivity. Reforms on public management (including the freeze of new PPP's for infrastructure projects) and the health system are very detailed and deep. On education, where action has been taken in recent years, and where Portugal lags many other countries, targets are softer. Reforms touch many other areas that affect productivity, such as the transport system, electricity (suppressing regulated prices and reducing subsidies) and telecoms (increase competition), housing (rebalancing tax incentives towards renting), professional services (implementing the EU directive), competition policy (more independence of competition authorities), judiciary system (to cut backlogs) and public procurement.

On the financial sector, the measures taken seem more than enough to cover stress scenarios in the banking system during the next three years. They address liquidity problems, increase solvency ratios (to 9% this year and 10% in 2012) and impose a rationalization of the banking system. They also address the problem of BPN and resources of bank supervision.

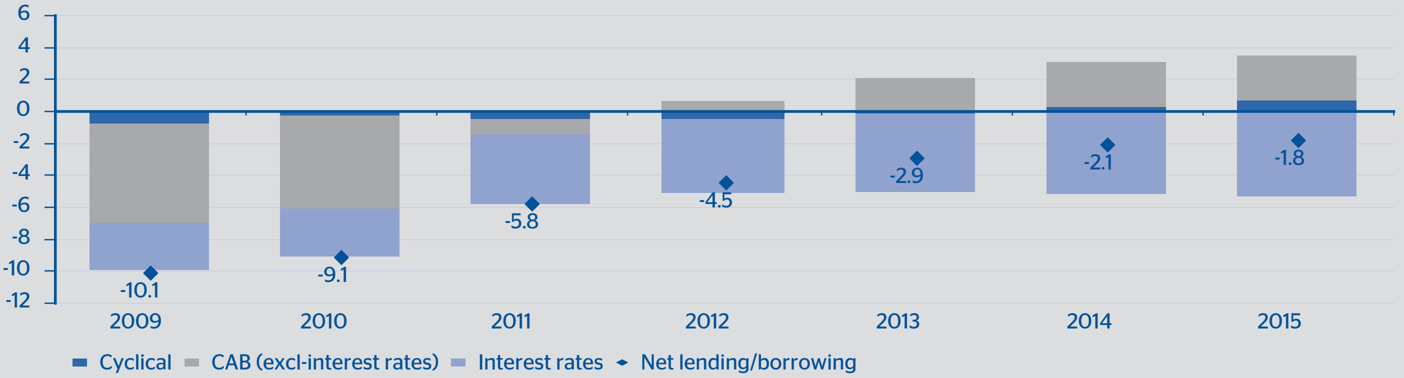
In sum, the programme can be considered very ambitious and very detailed in some areas, but not so much in others. If fully implemented, it would raise substantially the growth potential in the medium to long-term. Average growth in Portugal over the past ten years has been below 1%. A fully functioning economy, with the potential of catching up of Portugal, could raise that level to 2% or even more. However, this potential on the supply side has to go in parallel with a rebalancing of growth from the domestic to external sector, in which the very high current account balance (about 10% of GDP) and external debt are reduced. In this sense, the troika will have to be particularly vigilant on those reforms that aim at restoring competitiveness, such as those of wage bargaining and the rebalancing of taxes away from those which affect firm costs (something which is mentioned but not specified) to indirect taxes.

While the conditionality imposed on the financial aid programme will have a positive impact on the growth potential of the Portuguese economy, the strong fiscal retrenchment in the short-term has led the economy back into recession. In 2010, GDP grew by 1.4%, only slightly below the eurozone average. Underlying this growth were several exceptional factors that boosted both exports and private consumption. First, the strong recovery in external demand, as in other member states, as well as the eurozone recovery ended up boosting Portuguese exports. Second, private consumption was supported particularly by bringing forward consumers' purchases due to the increases in VAT in July 2010 and January 2011. However, activity contracted by 0.3% q/q in the last quarter of 2010, while the flash estimate for Q1 showed another fall of 0.7% q/q. Short-term data suggest that the Q1 fall would be explained by a significant drop in domestic demand. Expectations for the forecast horizon are not very encouraging, since the key fundamentals of private demand have continued to deteriorate. Regarding private consumption, further worsening in the labour marked, cuts in public wages, and accelerating inflation suggest that households' spending will shrink in 2011 and 2012, especially

Box 4: Portugal's rescue programme is broad-based, ambitious and focused on restoring growth (cont.)

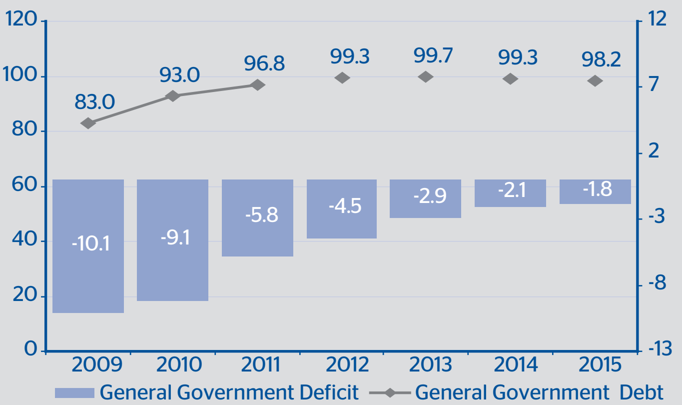
due the ongoing de-leverage process. Additionally, strong fiscal adjustment will also be felt through a sharp drop in public consumption and public investment. The fall in domestic demand will also end up reflecting in a drop of private investment. Therefore, exports will remain the key driver of growth, supported by strong global growth, which, given the expected fall in imports, will result in a high positive contribution from net exports. In short, our forecasts point to a GDP contraction of just over 1% in 2011, while the economy could stagnate next year after the frontloaded adjustment made this year tends to fade (Chart 24).

Chart 22
Portuguese fiscal deficit



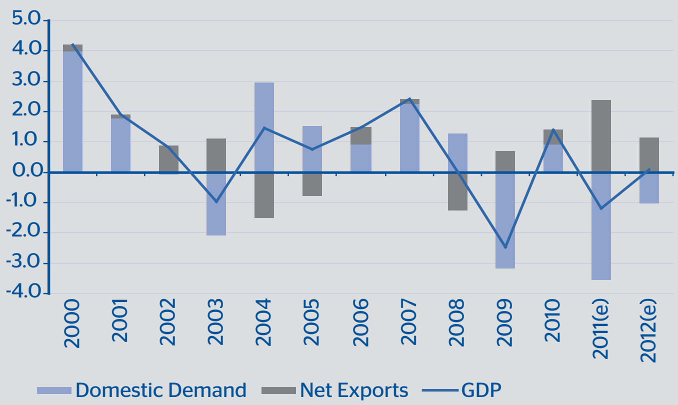
Source: European Commission and BBVA Research

Chart 23
Portuguese fiscal and public debt



Source: BBVA Research

Chart 24
Portugal: GDP growth and contributions



Source: Eurostat and BBVA Research

Box 5. Asset booms and tax receipts: The case for Ireland and Spain

Both Ireland and Spain enjoyed years of rapid growth accompanied with fiscal revenue increases. However, the crisis led to a rapid deterioration of their fiscal balances that, to a great extent, was not only the consequence of greater discretionary spending. These specific episodes lead to reconsider the nature of some fiscal revenues, as they may be of temporary nature as a consequence of asset price booms. Economic growth was driven by a sharp contribution of investment, particularly in dwellings that also contributed to the increase of direct and indirect tax revenues. The change in growth composition tilted towards investment in dwellings has led to large swings in tax revenues. In addition, corporate profits also showed a rapid growth in part related to this phenomenon. Tax bases for the different types of public revenues showed important increases during the boom period, which were followed by a sharp decline (and with no prospects of complete recovery) during the crisis.

The experience of Ireland and Spain calls for the necessity of implementing preventive fiscal surveillance beyond standard readings. On the one hand, it might help to detect asset booms and their effects. On the other, it could help to identify the potential size of the imbalances and their consequences. While the fiscal stance in both economies was in a good position during the pre-crisis period, it has proven to be very weak in the aftermath, as some fiscal revenues were tagged as structural and led to a permanent increase in spending that is difficult to cut during the crisis

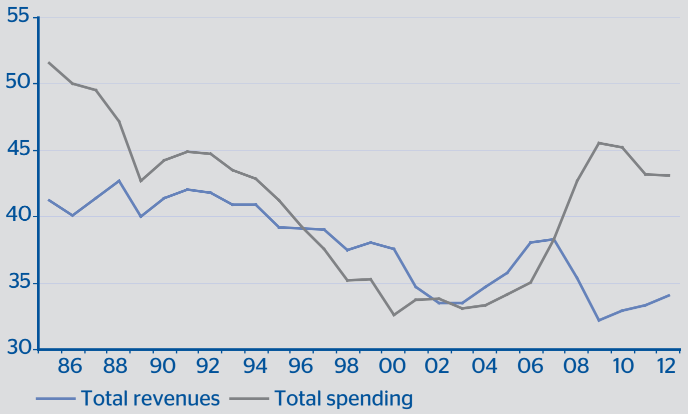
The rapid deterioration of fiscal balances is partly explained by permanent changes in public revenues

Prior to the crisis, Ireland and Spain were recording positive fiscal balances. Ireland posted surpluses almost for a decade accompanied with a rapid pace of economic growth. Similarly, Spain was an excellent complier of the SGP, with surpluses in 2008 and 2007 around 2 per cent of GDP. However, both economies have registered a particularly sharp deterioration of their fiscal balances during the crisis that have also translated in a sharp increase in public debt. Ireland public debt was at 25% of GDP and Spain at 37% in 2007, and closed 2010 at 103% (excluding NAMA) and 62% of GDP, respectively.

Although during the boom years there were some concerns about the nature of fiscal revenues, they were generally perceived as structural. However, neither the amount of discretionary measures (mostly through tax rebates) nor the effect of automatic stabilizers can fully explain the dramatic decline of revenues during the crisis.

Chart 25

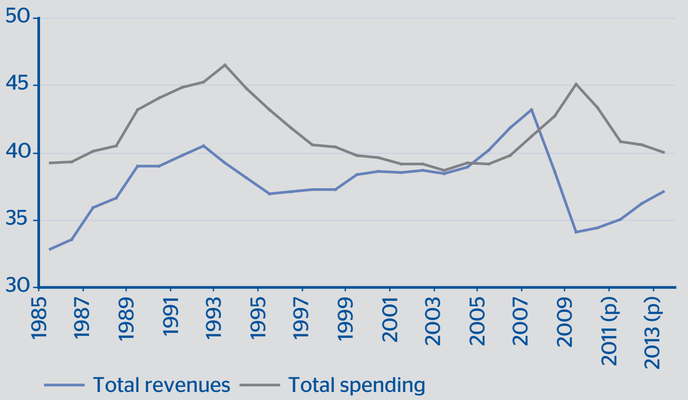
Ireland, Public revenues and expenditure (% of potential GDP)



Source: AMECO and BBVA Research

Chart 26

Spain, Public revenues and expenditure (% of potential GDP)



Source: AMECO and BBVA Research

What lies behind the deficit?

A closer view on the components of fiscal deficits yields some insights about the deterioration of budget balances.

A significant increase in public spending during the crisis, both through automatic stabilizers and discretionary measures

Letting aside the injections of public capital in the banking sector, in Ireland public expenditure increased by 6 pp of GDP in 2009 with respect its level in 2007, mainly because of the increase of social benefits and compensation to employees.

Box 5. Asset booms and tax receipts: The case for Ireland and Spain (cont.)

In Spain, the picture is quite similar, with an increase of almost 5 pp of GDP from 2007 to 2009, explained by the rise in social benefits (2.2 pp of GDP) and in government consumption. In both countries, the surge of unemployment benefits explains the increase in social benefits spending.

The fall in revenues is higher than that of nominal GDP

Part of the reduction in revenues is explained by the effects of automatic stabilizers along the economic cycle. According to historical elasticities for these two countries, at the aggregate level the decline of revenues is proportionally similar, so in previous business cycles the ratio of public revenues to GDP remained almost unchanged, as shown in Charts 25 and 26 for the economic crisis of early nineties. However, during 2008 and 2009 fiscal revenues in Spain and Ireland fell from peak to trough by -6.4 pp and -2.9 pp respectively, while for the eurozone as a whole the ratio just declined by -0.9 pp of GDP. Although the governments implemented expansionary fiscal policies through tax rebates, the magnitude of these discretionary measures is relatively small compared with the change in revenues. For example, in 2008 and 2009 the Spanish government implemented a reduction in personal income taxes equivalent to 0.5 pp of GDP, that is, only one sixth of the total fall in public revenues. Therefore, the sizeable reduction in fiscal revenues cannot only be explained by the fall in economic activity and the use of discretionary fiscal measures.

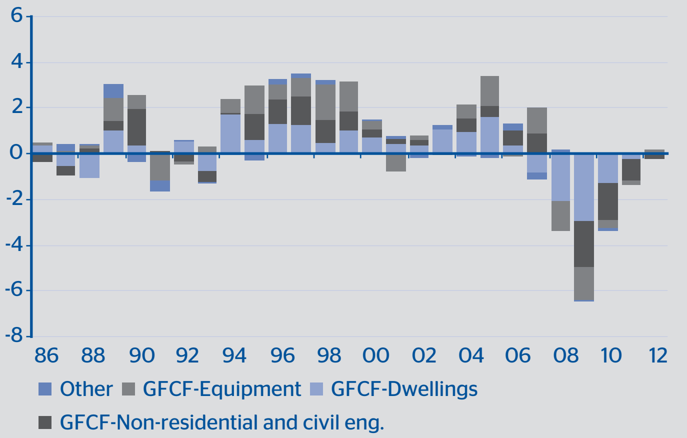
The end of the housing boom and corporate profits has permanently reduced some tax bases

From mid nineties Ireland and Spain grew at a fast pace, more rapidly than the rest of the eurozone and investment contributed substantially to this growth. Although investment in non-residential and civil engineering projects, or in equipment, which have large and persistent effects on growth, grew significantly due to relaxed financial conditions, particularly investment in dwellings also experienced a large and unsustainable boom. Since the start of the crises investment has decreased considerably and its correction seems to be near to completion. However, it is not expected that investment to GDP rates recover to previous levels. In the same line, the corporate sector also showed significant capital gains.

A closer view to the tax bases related to housing and corporate profits shows the effects of such booms on public revenues. Thus, in Spain revenues were growing at 3% on average, while the economy was growing at 2% on average. In Ireland this divergence at an aggregate level between economic growth and revenues is less notorious, but some items such as taxes on imports and production that accounted for 40% of total revenues registered an average growth of 5%, while nominal quarterly growth was hovering at around 2.5%. However, the fall in revenues once the crisis kicked in was sizeable. A significant fall in indirect taxes can be explained by the developments of household private consumption and investment in dwellings, since sales of new dwellings are subject to VAT and second-hand sales to other indirect taxes. In Ireland gross fixed capital formation in dwellings accounted at the peak for 14% of GDP in 2006, compared to an average close to 5% from mid eighties to mid nineties, fell to 4% in 2010 and are expected to remain below 3% in the next two years. In Spain, the housing boom was significantly smaller and during the peak investment in housing reached a 9% of GDP and currently stands slightly below at 5%.

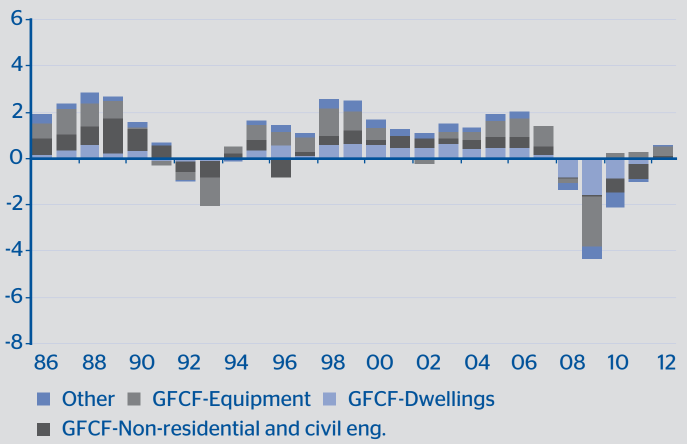
The tax base for corporate tax also increased sharply during the boom, well above its steady state (around 11% of GDP in Spain) that explains the sharp increases registered on production. While both in Spain and Ireland the tax base for the VAT in the building and construction sector jumped during the housing boom.

Chart 27
Ireland, Contribution of investment to growth in pp of GDP



Source: AMECO and BBVA Research

Chart 28
Spain, Contribution of investment to growth in pp of GDP



Source: AMECO and BBVA Research

Box 5. Asset booms and tax receipts: The case for Ireland and Spain (cont.)

Policy recommendations

The effects of asset booms on the budget balances of Ireland and Spain call for the implementation of preventive fiscal surveillance and add an additional argument in favour of monitoring closely unbalanced growth to avoid the existence of such bubbles. On the one hand, this strategy might help to detect an asset boom. On the other, it could help to identify the potential size of the fiscal imbalance and its consequences. While the fiscal stance in both economies was in a good position during the pre-crisis period, it has proven to be very weak in the aftermath, as some revenues have been tagged of a structural nature leading to an increase in spending that is difficult to cut.

Although, at the European level the task force led by Van Rompuy is working in this direction, given the complexity and the various sources of the fiscal imbalances, it is quite difficult to find a small set of indicators that can play the role of an early warning system. Conscious of the difficulties of anticipating fiscal imbalances, we propose here some policy recommendations:

- Improve the quality of underlying macroeconomic scenarios of fiscal budgets and detect potential asset bubbles. In most countries, projections of fiscal variables tend to be too optimistic, implying a deficit bias in public accounts. Additionally, when revenues are growing better than expected, due to the existence of asset booms, governments usually implement procyclical spending policies. In this situation, discretionary countercyclical fiscal policies may help to reduce the size of the boom and, in any case, may improve the margin of manoeuvre of fiscal policy when the economy adjusts abruptly.
- Improve the credibility in fiscal planning and the execution of the budget by closely monitoring fiscal developments. Although there is a great transparency in ex–ante medium term objectives through the Stability and Growth Programmes, their implementation tends to be too loose and medium-term programmes are rarely fulfilled (see, for example, Beetsma, Guiliodori and Walschot, 2010)
- Improve the assessment of the fiscal stance though a better institutional framework. Although the European Commission is currently acting as an external evaluating agency, also national agencies, as the Congress Budget Office in the US or the Office of Budget Responsibility in the UK, could complement the assessment of fiscal policies for national parliaments, which usually do not have the instruments and the capabilities to control the fiscal stance. In the same vein, fiscal rules for national and sub-national governments have proven to be quite useful in avoiding fiscal imbalances.

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Box 6: Greece: Between tough fiscal adjustment and debt restructuring

Stress has continued to hit European markets in April and May, and expectation among market participants that Greece may not being able to pay its debts and eventually needing to restructure them is at the heart of renewed financial tensions. The IMF+EU package for Greece was designed under the assumption that Greece could access financial markets issuing long term debt in 2012 in order to fund part of its financial needs. This is no longer possible under current market conditions, and therefore Greece must find other ways to finance itself. The government has already announced a privatisation process to raise EUR 50 bn of extra revenues until 2015. Although this is key to reduce its debt ratio to levels closer to sustainability, it would not be enough to solve its liquidity needs for 2012.

The most likely option in the short term is that IMF+EU will extend their financial support to Greece with strict conditions. These include not only a detailed privatisation process, but also additional fiscal consolidation measures to ensure that the current deficit targets are met (after the revision of fiscal figures in May), as well as broad political support of new measures. The new support to Greece could include around €60bn of fresh cash, the extension of the maturities of current loans by the IMF and the EU from the current 4 years to 7.5 years, and a reduction of interest rates by 100bp to about 4% (perhaps gradually and subject to fiscal consolidation targets). Despite the loose talk on "reprofiling" private debt by political authorities in Europe, we think that the extension of maturities will apply only to public debt in the short-term.

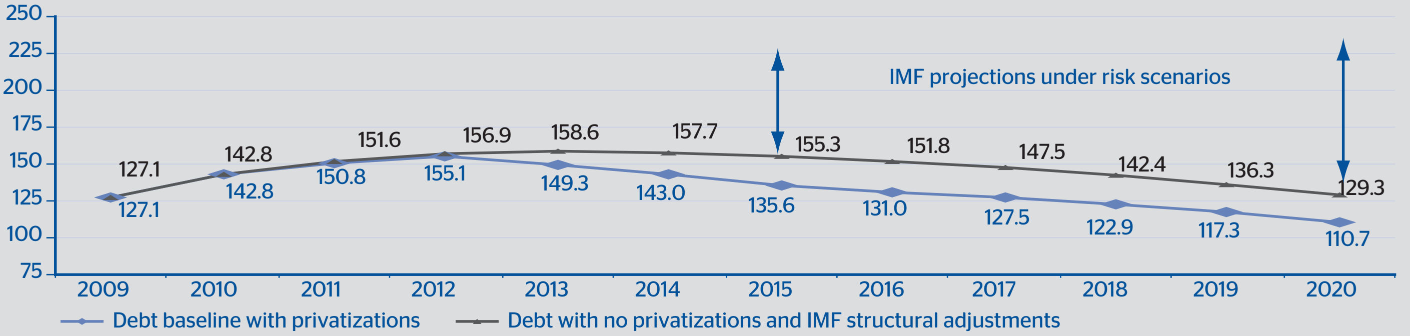
All these measures would provide Greece with some time to improve its account and demonstrate to its creditors that its debt can be sustainable in the long term (which is paramount for a country with a primary deficit and important external financing needs). It would be advisable that in the following months, clarifications on what a debt reprofile or a restructuring would look like and its potential consequences are explored in an orderly way among the European partners (and credible stress test are a necessary first step in that direction). Exiting from the eurozone does not make sense for Greece, since it would imply a sudden stop of its economy and would not avoid the necessary reforms, albeit a process by which Greece is in the future able to grow away of its debt should be clearer than what it is now in the minds of external observers.

On the issue of sustainability, Chart 29 shows the likely path of public debt with and without privatization, if everything goes as planned (growth returns to about 4% in nominal terms as from 2014, structural adjustment takes place as projected, and Greece is able to pay low interest rates for its debt (below 6%). A downward debt adjustment would require a permanent structural primary balance of around 5% of GDP for a long time, something which is hard to achieve, but once that figure is reached should be easy to maintain (other Eurozone countries, such as Ireland and Belgium, have been close to that figure for several years). To hit such a target further consolidation must be achieved. In Greece's favour there is the argument that the structural adjustment made in 2010 has been impressive (nearby 8pp of GDP, the highest reduction for a EZ country in the last 30 years). Against it, there is the argument of reform fatigue, lack of political consensus on fiscal measures, and especially the failure to raise fiscal revenues as projected due to the inability to fight against tax evasion. That, together with a credible privatization plan, is the main challenge faced by Greece at this moment.

The government has announced additional fiscal measures for €26bn for 2011-2015, of which €6.4bn will be implemented this year. New measures for 2011 are broad-based, and include further restraint in the public wage bill, rationalization of health costs, further cuts in social spending, additional taxes on luxury goods and moving some goods from lower to higher VAT rates. Still, there are measures for a value of €1.6bn that need to be identified to reach those €6.4bn. For the period 2012-2015, additional measures equivalent to €19bn have been identified, but are presented more as targets for different government areas and still need to be detailed.

On privatizations, the target of €50bn until 2015 is divided in €15bn from the sale of companies and infrastructure, and €35bn from the sale of real estate assets. The list of companies includes the remaining government stake on the main telecoms company and the post, several ports, the state lotteries and several infrastructure items (airports, motorways, water supply). Most of these are targeted for 2011 and 2012, while most of the sale of real estate would come afterwards.

Chart 29
Greece: Public Debt (% GDP)



Source: BBVA Research

4. Tables

Table 1
Summary of forecasts

Euro Area (YoY growth rate)	2008	2009	2010	2011	2012
GDP at constant prices	0.3	-4.0	1.7	1.7	1.5
Private consumption	0.4	-1.1	0.7	1.1	1.3
Public consumption	2.3	2.5	0.7	0.2	0.1
Gross Fixed Capital Formation	-1.0	-11.3	-0.8	1.8	2.7
Inventories (*)	-0.2	-0.7	0.4	0.0	0.0
Domestic Demand (*)	0.3	-3.3	0.8	1.1	1.3
Exports (goods and services)	0.7	-13.1	10.6	7.1	5.0
Imports (goods and services)	0.6	-11.8	8.7	5.7	4.9
External Demand (*)	0.1	-0.8	0.9	0.7	0.2
Prices and Costs					
CPI	3.3	0.3	1.6	2.7	1.6
CPI Core	2.4	1.3	1.0	1.7	1.7
Labour Market					
Employment	1.0	-1.8	-0.4	0.5	0.8
Unemployment rate (% of labour force)	7.5	9.5	10.0	9.7	9.3
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-2.0	-6.3	-6.0	-4.5	-3.5
External Sector					
Current Account Balance (% GDP)	-0.9	-0.6	-0.5	0.0	0.1

Source: Eurostat and BBVA Research

Table 2
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2008	2009	2010	2011	2012
United States	0.4	-2.6	2.9	3.0	2.7
EMU	0.3	-4.1	1.7	1.7	1.5
UK	-0.1	-4.9	1.3	1.4	1.6
Latin America *	5.3	-1.1	6.6	4.6	4.4
EAGLES **	6.6	3.5	8.3	6.9	6.9
Turkey	0.7	-4.7	8.1	4.6	4.8
Asia Pacific	5.6	3.8	8.0	6.4	6.7
China	9.6	9.2	10.3	9.4	9.1
Asia (exc. China)	3.0	0.2	6.5	4.3	5.1
World	3.0	-0.6	4.9	4.4	4.4

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2008	2009	2010	2011	2012
United States	3.8	-0.3	1.6	2.8	2.2
EMU	3.3	0.3	1.6	2.7	1.6
UK	3.6	2.2	3.3	4.0	2.2
Latin America *	8.8	6.9	7.4	8.1	7.1
EAGLES **	7.4	2.8	5.2	5.2	4.7
Turkey	10.4	6.3	8.6	6.3	6.4
Asia Pacific	5.7	0.3	3.6	4.4	3.7
China	6.0	-0.7	3.3	4.9	4.2
Asia (exc. China)	5.5	1.0	3.7	4.1	3.4
World	6.1	2.2	3.7	4.7	4.0

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Current Account (% GDP)

	2008	2009	2010	2011	2012
United States	-4.7	-2.7	-3.3	-3.5	-3.4
EMU	-0.9	-0.6	-0.5	0.0	0.1
UK	-1.6	-1.3	-2.2	-1.5	-0.2
Latin America *	-0.7	-2.5	-0.9	-0.7	-1.5
EAGLES **	4.0	2.3	1.9	1.5	1.3
Turkey	-5.6	-2.2	-6.6	-6.9	-6.6
Asia Pacific	4.8	3.8	3.2	2.9	2.9
China	9.9	6.1	5.2	4.5	4.5
Asia (exc. China)	1.4	2.3	1.8	1.8	1.8

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Government Deficit (% GDP)

	2008	2009	2010	2011	2012
United States	-3.2	-10.0	-8.9	-9.7	-7.6
EMU	-2.0	-6.3	-6.0	-4.5	-3.5
UK	-5.0	-11.4	-10.4	-9.5	-7.1
Latin America *	-1.1	-8.3	-2.1	-2.2	-2.3
EAGLES **	-1.8	-5.3	-3.6	-2.8	-2.4
Turkey	-1.8	-5.5	-3.6	-3.0	-2.8
Asia Pacific	-2.8	-5.1	-4.7	-4.2	-3.7
China	-0.4	-2.2	-2.5	-2.0	-1.8
Asia (exc. China)	-4.4	-6.5	-6.1	-5.6	-4.9

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 6
Financial Variables

Official Interest Rates (End period)	2008	2009	2010	2011	2012
United States	0.61	0.25	0.25	0.25	1.25
EMU	2.73	1.00	1.00	1.50	2.00
China	5.31	5.31	5.81	6.81	7.31
10-year Interest Rates (Avg.)					
United States	3.6	3.2	3.2	3.7	4.2
EMU	4.0	3.3	2.8	3.4	3.6
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.68	0.72	0.76	0.73	0.75
EMU	1.47	1.39	1.33	1.37	1.33
UK	1.82	1.56	1.55	1.64	1.66
China	6.95	6.83	6.77	6.46	6.14

Forecast closing date: April 30, 2011
Source: BBVA Research

Table 7
Germany: GDP growth and inflation forecasts

YoY growth rate	2008	2009	2010	2011	2012
Private consumption	0.6	-0.1	0.4	1.3	1.4
Public consumption	2.3	2.9	2.3	1.2	0.9
Gross Fixed Capital Formation	1.8	-10.0	5.7	6.4	4.9
Inventories (*)	-0.2	0.1	0.6	0.0	0.0
Domestic Demand (*)	0.9	-1.5	2.3	2.3	1.9
Export	2.0	-14.3	13.8	7.6	6.9
Import	2.9	-9.4	12.4	7.5	7.7
Net export (*)	-0.2	-3.2	1.2	0.4	0.0
GDP	0.7	-4.7	3.5	2.7	2.0
Inflation	2.8	0.2	1.2	2.6	1.8

(*) Contribution to growth
Source: BBVA Research

Table 8
France: GDP growth and inflation forecasts

YoY growth rate	2008	2009	2010	2011	2012
Private consumption	0.5	0.6	1.6	1.5	1.7
Public consumption	1.6	2.8	1.4	0.5	0.3
Gross Fixed Capital Formation	0.3	-7.0	-1.6	3.1	3.3
Inventories (*)	0.3	-1.9	0.1	0.1	0.0
Domestic Demand (*)	0.4	-2.4	1.1	1.8	1.7
Export	-0.8	-12.2	9.9	6.4	6.3
Import	0.3	-10.6	7.8	6.0	5.9
Net export (*)	-0.3	-0.2	0.4	0.0	0.0
GDP	0.1	-2.5	1.5	1.7	1.6
Inflation	3.2	0.1	1.7	2.3	1.6

(*) Contribution to growth
Source: BBVA Research

Table 9

Italy: GDP growth and inflation forecasts

YoY growth rate	2008	2009	2010	2011	2012
Private consumption	-0.8	-1.8	1.0	0.8	0.9
Public consumption	0.5	1.0	-0.6	-0.1	0.1
Gross Fixed Capital Formation	-3.8	-12.0	2.3	1.7	1.9
Inventories (*)	-0.2	-0.6	0.8	0.0	0.0
Domestic Demand (*)	-1.4	-4.0	1.8	0.8	0.9
Export	-4.4	-18.4	8.9	5.4	5.1
Import	-4.4	-13.8	10.3	4.2	4.3
Net export (*)	0.0	-1.2	-0.5	0.2	0.1
GDP	-1.3	-5.2	1.2	1.0	1.0
Inflation	3.5	0.8	1.6	2.7	1.9

(*) Contribution to growth
Source: BBVA Research

Table 10

Portugal: GDP growth and inflation forecasts

YoY growth rate	2008	2009	2010	2011	2012
Private consumption	1.8	-1.0	2.0	-1.6	-0.8
Public consumption	1.1	3.4	3.2	-6.4	-1.6
Gross Fixed Capital Formation	-1.8	-11.6	-4.8	-5.8	-0.9
Inventories (*)	0.3	-0.6	-0.2	0.0	0.0
Domestic Demand (*)	1.3	-3.2	0.9	-3.6	-1.0
Export	-0.3	-11.6	8.7	6.3	5.4
Import	2.8	-10.6	5.3	-1.0	1.8
Net export (*)	-1.2	0.7	0.5	2.4	1.1
GDP	0.0	-2.5	1.4	-1.2	0.1
Inflation	2.7	-0.9	1.4	3.2	2.1

(*) Contribution to growth
Source: BBVA Research

Table 11

Spain: GDP growth and inflation forecasts

YoY growth rate	2008	2009	2010	2011	2012
Private consumption	-0.6	-4.3	1.3	0.4	0.9
Public consumption	5.8	3.2	-0.7	-1.1	-0.3
Gross Fixed Capital Formation	-4.8	-16.0	-7.5	-3.8	2.4
Equipment and other products	-3.0	-21.2	-2.1	1.3	4.0
Construction	-5.9	-11.9	-11.1	-7.7	1.2
Housing	-10.7	-24.5	-16.5	-7.5	3.6
Other construction	-0.8	-0.1	-7.2	-7.8	-0.1
Inventories (*)	0.1	0.0	0.1	0.0	0.0
Domestic Demand (*)	-0.6	-6.4	-1.1	-0.9	1.0
Export	-1.1	-11.6	10.3	10.6	6.2
Import	-5.3	-17.8	5.5	3.7	3.6
Net export (*)	1.5	2.7	1.0	1.7	0.6
GDP	0.9	-3.7	-0.1	0.9	1.6
Inflation	4.1	-0.3	1.8	2.9	1.3

(*) Contribution to growth
Source: BBVA Research

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