BBVA | RESEARCH

Economic Outlook

Europe

Fourth Quarter 2011
Economic Analysis

- **Eurozone projections revised downwards** on account of heightened stress in financial markets
- **Measures taken at European summits in October still leave key elements unresolved.** Quick implementation is essential to avert a recession.
- **ECB has extended bank liquidity measures, is reducing rates back to 1%** and should maintain purchases of sovereign debt.

Index

Closing date: November 7th 2011

1. Global slowdown and risks tilted to the downside

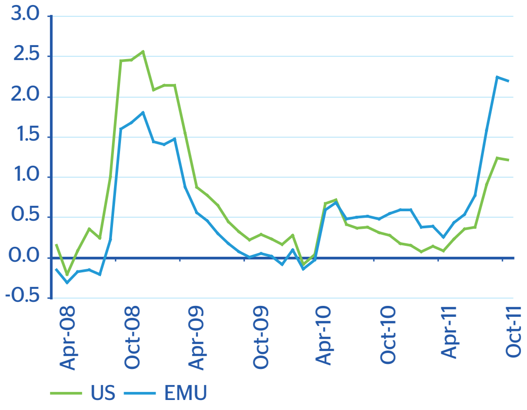
The global economy slows down and the outlook is heavily dependent on the resolution of the European debt crisis. Risks are strongly tilted to the downside

The outlook for the global economy has worsened over the past few months, driven mainly by four factors that are still exerting their influence. First, lower than expected economic growth mainly, but not only, in developed economies (data had been already disappointing in the US in the first half of the year, which led some analysts to expect a double dip). Although growth increased in the US in the third quarter, economic activity in Europe, which held very well in the first quarter, is now on a clear decelerating path. Second, the sovereign debt crisis in Europe has intensified and turned more systemic. While decisions announced in the October summit go in the right direction, there are still key elements unresolved, especially regarding the real firepower of the mechanisms for providing sovereign liquidity (a leveraged European Financial Stability Fund or EFSF), the restructure of Greek debt held by private investors, and a clear roadmap for advancing European governance towards a fiscal union. Third, the feedback between sovereign concerns and the health of the European financial system has intensified, and financial tensions in Europe have reached levels in many respects higher that after the fall of Lehman Brothers in October 2008 (see Chart 1). This increases the risk of a negative impact on economic activity, further feeding a real-financial vicious circle. Finally, higher global risk aversion has increased financial market volatility significantly, spilling over to most risky assets, including emerging economies for the first time since 2009.

In this context, we revise downward our global growth forecasts by 0,3pp in 2011 and 2012, relative to our previous publication, mostly due to lower expected growth in advanced economies (US and Europe, compensated in part by Japan), although emerging markets will also grow slightly less than previously anticipated. Thus, the global economy would grow by 3.9% in 2011 and 4.1% in 2012, supported by solid growth in emerging economies against lackluster performance in advanced countries (see Chart 2).

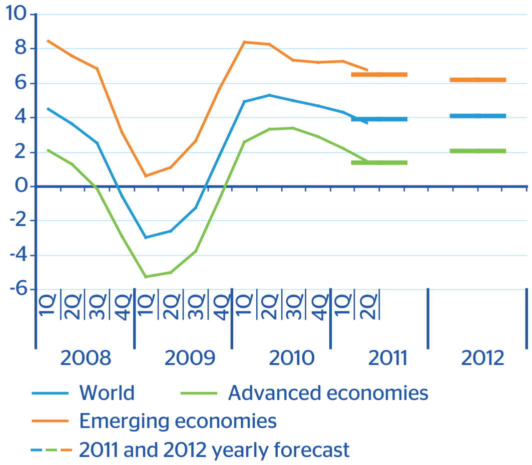
These are still robust growth rates, but risks to these projections are now strongly tilted to the downside, hinging in the short term on the evolution of the sovereign-financial crisis in Europe. In particular, a quick reduction of financial stress in Europe is needed to avoid a sharp effect on growth there and in other regions through financial exposures and global risk aversion.

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

Some improvements in US growth in Q3, but structural weaknesses remain, including from political deadlock

On the positive side, growth in the US seems to have reaccelerated in the third quarter, at least according to preliminary estimates. This is not saying much –growth in the first two quarters was very low and the output gap is still very high– but seems to have reduced market nervousness about a double dip. Nevertheless, the structural weakness of the US economy remains, as consumer and business confidence continue to be weak and the housing market could adjust further. This means lower resilience in the face of a possible shock coming from Europe. In addition, political deadlock could impede a "grand bargain" to (i) prevent an unintended fiscal contraction in the short run and (ii) push reforms towards a credible fiscal consolidation in the long run.

Emerging economies are on track for a soft landing, but with increasing external headwinds

Emerging economies continue growing strongly, supported by the resilience of domestic demand. Still high commodity prices for Latin America and export growth in Asia –despite strong corrections in both cases– also contribute to a rapid growth outlook, which is on track for a much-awaited soft landing, which would be welcome in some countries. Renewed turmoil in Europe and the US imply important headwinds from financial markets in Latin America and Asia –reflected in increased market volatility, depreciated exchange rates and reduced capital inflows–. However, many countries also enjoy sizable buffers –stronger public finances and better macroeconomic management than in the past– and are well positioned to introduce policy stimulus to counter weaker external demand. Overall, a more negative external environment has switched the focus in emerging countries from overheating to downside risks and, increasingly, to the possible need for policy support.

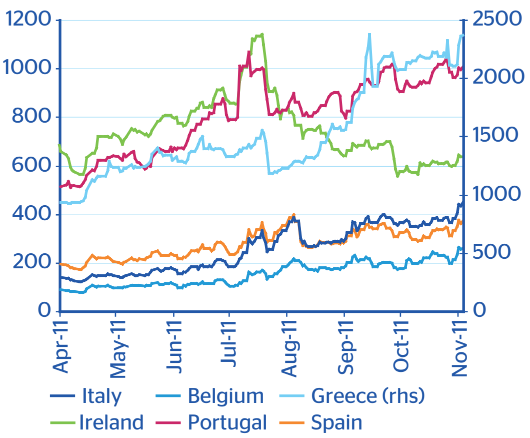
2. Still waiting for a definitive solution to the European crisis

The sovereign debt crisis in Europe intensified since August, and spilled into funding pressures in the financial sector. Economic activity also shows clear signs of deceleration

Despite the agreements reached at the July EU summit, sovereign debt markets remained under intense pressure since mid-August, including those of Spain and, crucially, Italy (see Chart 3). At the heart of sovereign tensions were doubts about the pace of implementation of the agreements, including improvements in the EFSF (which was finally ratified by all countries in October) and the so-called private sector involvement (PSI) in the new Greek rescue package, which in the end was superseded by deteriorating market valuation of Greek debt. In addition, the fact that sovereign tensions reached Italy in full force (with spreads above Spain for the first time since the beginning of the crisis) made it clear that the EFSF would be too small to prove an effective firewall to contagion from Greece.

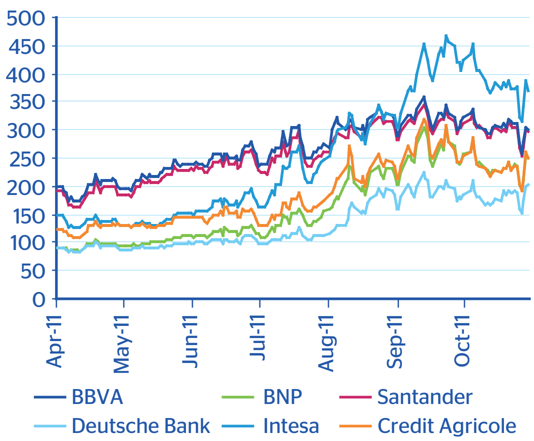
In addition, the sovereign debt crisis in Europe started to undermine confidence on European banks, many of which are heavily exposed to sovereign debt of peripheral countries. Banks were also affected on the liability side of their balance sheets as the quality of implicit government guarantees was eroded. Potential losses increased concerns about the solvency of some banks and led to a severe tightening of funding markets, even for some banks in core European countries. These pressures were reflected in a sharp increase in banks' CDS spreads (see Chart 4) above those observed after the fall of Lehman Brothers.

Chart 3
Sovereign debt spreads in Europe (bps, versus German 10y bonds)



Source: BBVA Research

Chart 4
CDS spreads (5Y) for big eurozone banks (bps)



Source: BBVA Research

The feedback between sovereign concerns and stress in financial institutions increasingly run the risk of starting to impact on economic activity in the eurozone. Funding pressures for European financial institutions –including in US dollars–, increased the risk of a deleveraging of bank balance sheets and a sharp reduction of credit, thus amplifying the effect of the shock on sovereign debt on economic activity. In fact, after a strong first quarter boosted by favorable weather, euro area economic activity in the second quarter decelerated markedly. Going forward, survey data seem to paint a more pessimistic picture than hard data, and activity most likely will remain flat in Europe in Q3 and Q4 (see below).

The October European Summits have taken measures that are in the right direction, but still leave key elements unresolved. This does not bode well for the reduction of financial stress in Europe

European authorities have reacted to the stress in financial markets and the deterioration in Greece with a series of measures that try to address problems from several angles. Broadly speaking, they have faced the situation of the banking sector with a recapitalization plan for European banks, while Greece is still in the process to receive a second rescue package which implies a larger contribution by the private sector and tries to make Greek debt sustainable. Finally, just after the new EFSF provisions proposed during the July 21st summit were approved by national parliaments, EU authorities started to analyze the possibility of expanding the power of the EFSF to support sovereign debt markets, given the perceived lack of capacity of the current one to face doubts about Italian and Spanish debt with the nominal lending capacity of the fund.

This strategy crystallized in one EU summit at the highest level on October 23rd, and finalized in another summit three days later where a broad set of measures was proposed (see Box 1). The overall evaluation of these measures is positive, in the sense that they address the insolvency of Greece and considerably expands the firepower of the EFSF. The recapitalization programme reinforces the resilience of the banking system by forcing banks to raise their capital ratios, although it does it in an inefficient way and does not help to counteract market suspicions on the debt of sovereign countries which are solvent. Furthermore, the agreements lack detail in many respects, leaving them for negotiations in coming months, in such a way that the jury is still out on their effectiveness. In the sections ahead we have a look at the main issues addressed during the summit, and the questions related to them that remain open.

Box 1. What exactly was proposed in the Summit?

1. **On Greece:** A haircut of 50% to private investors, with credit enhancements by €30bn, to bring Greek debt sustainable at 120% of GDP by 2020. Closer monitoring and control of Greek reforms, with in-site work of the Commission. The second rescue plan is postponed again to the end of 2011. The amount of official aid will be €100bn until 2014.
2. **On other peripheral countries:** Recommendations of further actions to Spain and especially Italy.
3. **On the EFSF:** The expected expansion of EFSF power through an Special Purpose Vehicle (SPV) and an insurance scheme on bond issuance, with no details, with an expected leverage of 4 or 5 times (around €1 trillion). Details are expected to be determined in November.
4. **On bank recapitalization:** A 9% minimum core tier 1 capital ratio to be reached before June 2012, where sovereign debt and loans have to be valued at market prices, and additional measures on liquidity to be determined by the EU Commission in the future, such as guarantees for banks' issuance.
5. **On governance:** Numerous provisions to reinforce governance and move towards more economic and fiscal integration, including a fiscal tsar in the Commission. There is no reference to Eurobonds and commitment to further changes by March 2012 including Treaty changes.

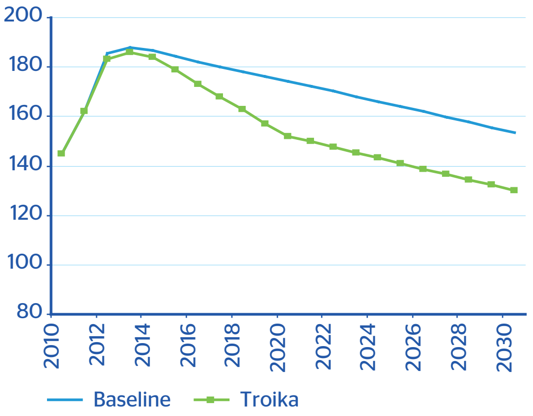
The new Greek program: the 50% haircut to private debt does no clear all doubts

The discount applied in the new program to private investors of 50% is a realistic equilibrium between a sizeable reduction of Greek debt and voluntary participation. There is a target of bringing a debt ratio at 120% of GDP by 2020, which is line with the current Italian debt as it would have been politically difficult to set it below that level. This target is sustainable, as is also corroborated by the troika analysis. Under our estimates, with moderate assumptions on growth (converging to 1.8% after 2015), inflation (converging to 0.9%), primary balance (to 3.8% of GDP) and interest rates (4.6%), the debt to GDP ratio falls to 134% of GDP after a 50% haircut to private debt, and then to 117% of GDP by 2020 (see Chart 5). This also assumes a recession in 2012 and almost stagnation in 2013, while most of the fiscal adjustment is implemented.

Despite being sustainable, the new path leaves many open questions.

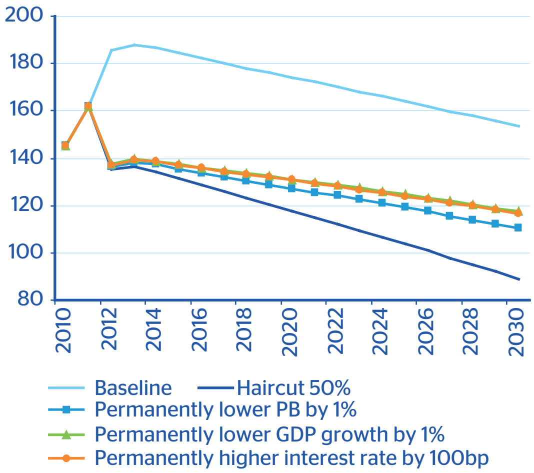
- First, the market may not believe that this level is sustainable, as the debt ratio is very sensitive to the assumptions underlying these calculations (see Chart 6). Lower growth would trigger higher debt rapidly, but also marginal adjustments in the budget would reduce it. Indeed, both CDS and bond markets are discounting a larger loss, above 60%. In any case, if the debt ratio by 2014 is still 134%, as expected, probably further official support will have to be approved by then as Greece will not be able to return to markets.
- Second, political and implementation risks remain high, despite the relief to Greece of lower debt and lower interest payments. The close intervention of the EU Commission in situ will help to enhance implementation, but could also be badly received by the Greek population. The fiscal adjustment ahead is still large. Indeed, most of the risks on Greece remain in the medium term, when the adjustment has to continue in a framework of economic recession. Once and if the adjustment of the deficit is made, the outlook for debt sustainability should be clarified.
- Third, there is a still risk that the voluntary participation in the PSI is low, and the haircut would have to be involuntary, which would trigger a credit event in CDS markets.

Chart 5
Greece: Public Debt (as % of GDP). Baseline without debt haircut



Source: Eurostat and BBVA Research

Chart 6
Greece: Public Debt (as % of GDP). 50% haircut and sensibility analysis



Source: Eurostat and BBVA Research

Other peripherals: Pressure on Spain and specially Italy

The EU continues to insist on structural reforms in the rest of the periphery. The final communiqué has a short reference to Ireland and Portugal and welcomes the advances they have made, while asking for continuing with the adjustment. It is somewhat more positive on Ireland than on Portugal. On Spain, it reiterates the recommendations on the three usual areas: fiscal adjustment, deepening labour market reform, with a special reference to wage bargaining system, and continuing to pursue the restructuring of the financial sector. The Council put special pressure on Italy, as the reforms plan presented by the Italian government to the summit was not very detailed. It asks to present more concrete steps ("an ambitious timetable is a matter of urgency") and mentions structural reforms in many areas, inviting the Commission to assess and monitor these measures. More recently, during the G20 summit of early November, Italy's economy has been put also under monitoring of the IMF, after the government declined the financial help offered by the organisation. All these measures are part of strong peer pressure, and cannot be forced upon them yet, but it will be positive once the EFSF is operating.

EFSF: Higher firewall to avoid contagion, but few details

In order to expand the capacity of the EFSF to deal with liquidity problems by periphery countries, the EU summit proposed two mechanisms, and insurance scheme for new issuance of sovereign bonds and an SPV to intervene in primary and secondary markets, although with no details on their operation, which will be discussed at an upcoming Eurogroup meeting. The SPV mechanism will be able to incorporate the eventual contribution of the IMF and other official and private investors. The access to this liquidity tools will be subject to strict conditionality.

The leverage mentioned by the Council is of 4 or 5 times, which implies a firepower of about €1 trillion, or slightly more. This would be sufficient to cover the issuance of Italian and Spanish bonds for two (€630bn) or three years (near €900bn), but is probably not the overwhelming response that would shut off market speculation. It will not work as an immediate ring fence of the rest of the periphery, as would have been desirable. In this sense, the easiest way to counter market jitters on large sovereigns would be to activate the role of the ECB as a lender of last resort. This is still a possibility in the case that stress continues, as the EU agreement has not closed the door to the Securities Markets Programme (SMP) by the ECB, as Germany originally wanted. The option of leveraging the EFSF directly with the ECB is also open for the future.

Banking system: A funding problem is recognized but stress is put on recapitalization

Regarding the banking system, the agreements touch two key points:

1. Bank recapitalization, valuing sovereign exposures in the banking book at market value and setting the minimum core tier 1 capital at a 9%. In principle, banks will have to raise approximately €106bn by the end of June-12. Capital will be obtained via financial markets, otherwise via national governments, and only after those two options are exhausted, via the EFSF. Spanish banks will have to raise the second highest amount among European countries, €26.2bn of capital buffer (€6.3bn sovereign capital buffer) due to the fact that current capital levels are far from the 9% minimum and to a lesser extent because all sovereign exposures have to be at market value, including the exposure to Spanish debt and loans.
2. The Commission has been asked to urgently explore options to address liquidity problems together with the EBA, EIB, ECB to provide long term liquidity, such as guarantees for bank issuance.

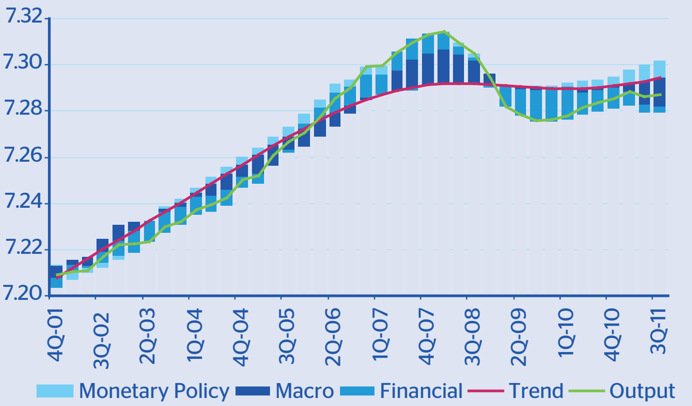
Box 2. New short-term capital requirements on eurozone banks: Moderate negative effects on lending and economic activity which may be offset by a positive impact on wholesale funding for banks

This box tries to assess the effects of one of the measures adopted in the European Summit of October 26th on the eurozone economy, i.e. the mandatory increase in banks' high-quality capital (core tier 1) as a proportion of their risk-weighted assets to 9% by the end of June 2012, after valuing sovereign debt and loans at market prices. This assessment is done through a simulation of higher capital ratios using a dynamic general equilibrium model that incorporates the banking sector.

Our simulation establishes a maximum potential cost of the new measure. Prudential financial policies such as this one tend to make banks more resilient in times of asset losses, but could also result on higher average lending interest rates if the new regulations impose higher funding costs on banks. However, in the current juncture it is expected that the important potential benefits from recapitalization could offset the potential costs - especially if, as the estimates we present below indicate, these potential costs are moderate.

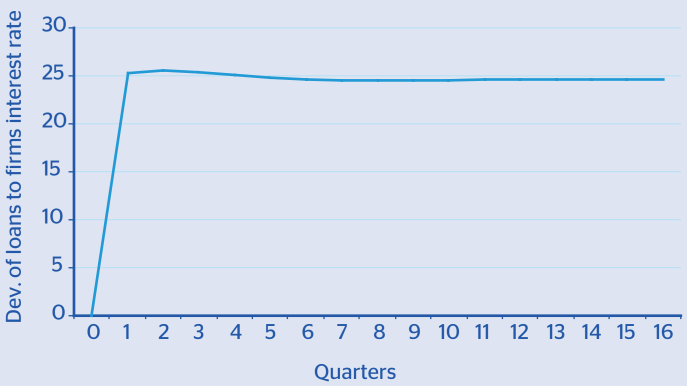
A first justification of higher capital requirements is that they may help to avoid future risk scenarios originated by financial shocks, which would have large spillover effects onto the rest of the economy. As observed through the recent financial turmoil, financial shocks could have strong impact on economic confidence and activity in the absence of such capital buffers,. In this sense, the new recapitalization measures try to prevent that an accident in the European sovereign debt crisis triggers a Lehman-like drop in confidence that would result in a halt of financial markets activity. A second justification for higher capital ratios lies in the need to reopen funding markets for European banks. In particular, according to the statement of EU summit by end-October[1], these measures should address: (i) the need to ensure the medium-term funding of banks, in order to avoid a credit crunch and to safeguard the flow of credit to the real economy; and (ii) the need to enhance the quality and quantify of capital of banks to withstand shocks and to demonstrate this enhancement in a reliable and harmonized way.

Chart 7
Eurozone: Output, trend and shocks



Source: BBVA Research

Chart 8
Loans interest rates: impact effects of European banking recapitalization (in bp)



Source: BBVA Research

Even in the case that these potential benefits from recapitalization do not materialize, the potential costs in terms of lending and economic activity contraction will be probably lower than what we estimate below, given that there are several recapitalization strategies at eurozone banks disposal that do not result in a reduction in lending to the private sector.

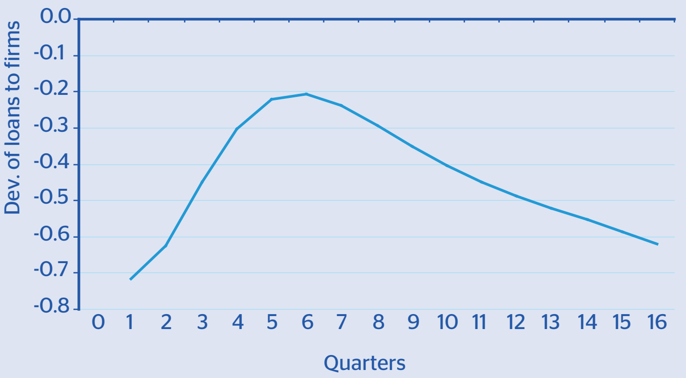
The rest of the box presents our estimates of the potential costs associated to the new capital requirements, but without taking into account the positive effects from recapitalization described above, since they are uncertain in the current situation. In this sense, they can be considered as an upper bound to the negative effects of recapitalization.

To gauge the macroeconomic and financial impact of this capital increase, we use the DSGE model with banking sector estimated for the eurozone and presented in our previous Europe Economic Outlook in the August of 2011. As already mentioned in previous issues of this publication, estimated DGSE models constitute a better tool as most alternatives to disentangle (technically, "identify") the deep causes from the effects in the analysis of a set of correlated macroeconomic and financial variables. This is the problem we face in the present case, where we need to isolate the causal effect of a variation of banks' capitalization on lending, economic activity and other macroeconomic and financial variables from the usual correlation between these variables.

1: See Annex 2, Euro Summit Statement, October 26, 2011. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf

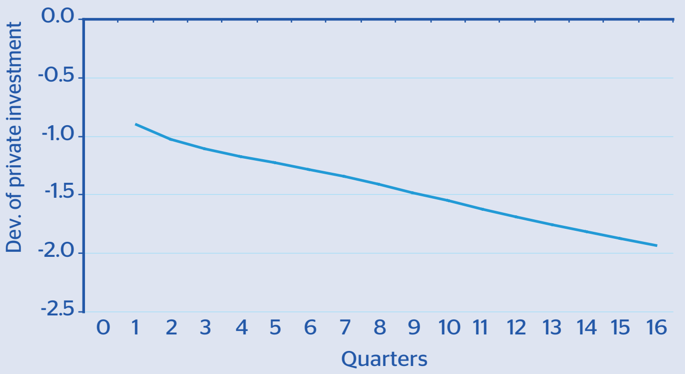
More specifically, the DSGE model employed, by incorporating explicitly the influence of capital requirements in the behavior of the eurozone's banks, allows to simulate very precisely the event in question; namely, the mandatory increase of banks' core capital as a proportion of total risk-weighted assets by a magnitude that we estimate to be of 1pp before june 2012; and quantify its probable effects on the eurozone's main macroeconomic and financial variables in a much more reliable way than mere accounting exercises or the use of more traditional statistical tools.

Chart 9
Loans to firms: impact effects of European banking recapitalization (in %)



Source: BBVA Research

Chart 10
Investment: impact effects of European banking recapitalization (in %)



Source: BBVA Research

The results of this simulation show that, ceteris paribus, increasing capital requirements induce banks to shift liabilities from debt (deposits) to bank equity. In particular, deposits could decline by around 2.5% by end Q2 2012. The cost-increasing composition effect is mitigated by a fall in banks' demand for deposits. In addition, the composition effect dominates the deposit interest rate effect, leading to an increase in funding costs for banks, which end up shifting onto the interest rate of loans to both households and firms. As a result, loans interest rates will increase by around 25bp in three first quarters, and loans volumes given to households and firms will fall significantly. The impact on the real economy runs mainly via investment (a fall of around 1.2% over the first year) and to a lesser extent through consumption (a drop of around 0.1% over the first year). Hence, and according to our model, an increase in capital requirements by 1pp to be met in three quarters would induce a GDP loss in the eurozone of around 0.2pp after one year or 0.3pp after four years. These results are approximately in between the effects estimated by the European Commission[2] (-0.1pp) and the IIF[3] (4.1pp), although closer to the latter in the long-run.

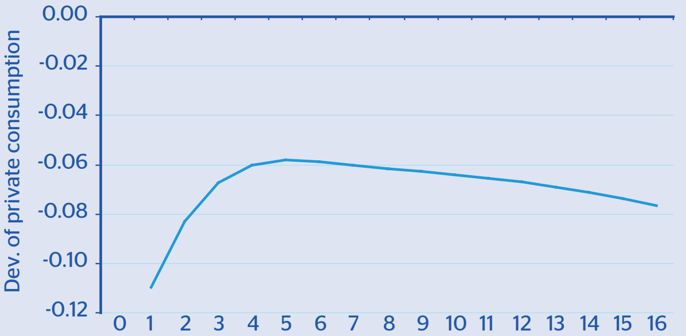
Nevertheless, to interpret the above results, we must keep in mind that the increase in the capital ratio was already a measure required by Basel III, which envisaged such a change in four years. Indeed, the EU summit decision mainly entails the frontload of that measure. Taking this into account, the anticipation of the new capital requirement by 1pp (to be met in three quarters instead of the longer period previously assumed) would induce a GDP loss of around 0.1pp after one year, and around 0.2pp in the long-run.

As mentioned above, the estimated effect could also be offset by reopening funding markets as well as by confidence gains. In addition, the financing of capital increase could be accomplished through several strategies that do not imply necessarily strong credit restrictions. First, the ECB will continue to provide liquidity in coming quarters, remaining as an essential part to limit deleveraging actions. Second, European banks could deleverage through a reduction of non-core activities, or even they could reallocate their assets portfolio throughout risks weighted assets. Finally, commercial banks may also decide to redistribute a lower share of profits in the short term to attain with the capital ratio increase. All these strategies would dampen the effect of recapitalization on credit supply and activity. Even more, some of these measures have been foreseen by the EU summit, as the communiqué suggested that banks should first use private sources of capital, including the restructuring and conversion of debt to equity instruments. If necessary, national governments should provide support, and if this support is not available, recapitalization should be funded via a loan from the EFSF in the case of eurozone crisis.

Summing up, although the effects are not negligible, our results show that the application of the new capital requirements would have at worst mild effects on lending, economic activity or other macroeconomic and financial variables, which will be very probably amply offset by their beneficial effects on banking funding opportunities and the use of non-reducing-lending recapitalization strategies by banks.

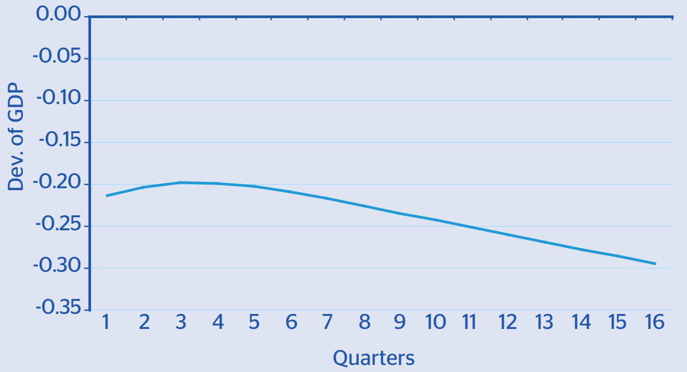
2: Quarterly Report on the Euro Area, Volume 10 Nº 1 (2011), "Economic impact of changes in capital requirements in the euro-area banking sector"
3: Institute of International Finance, June 2010 "Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework

Chart 11
Consumption: impact effects of European banking recapitalization (in %)



Source: BBVA Research

Chart 12
Output: impact effects of European banking recapitalization (in %)



Source: BBVA Research

Table 1
Transition and long-run effect of a 1pp increase in capital requirement in the eurozone to be **fulfilled by June 2012** (% deviation from baseline): BBVA Research vs. European Commission (in parenthesis)

	Year 1	Year 4	Year8
GDP	-0,20	-0,29	-0,42
	(-0,05)	(-0,10)	(-0,15)
Investment	-1,17	-1,93	-2,62
	(-1,12)	(-1,23)	(-1,15)
Consumption	-0,06	-0,08	-0,13
	(0,18)	(0,13)	(0,03)
Loans	-0,89	-1,20	-1,68
	(-0,10)	(-0,40)	(-0,52)
Deposit	-2,54	-2,90	-3,26
Loans rate (1)	25,09	24,61	24,61
	(-1,00)	(10,49)	(12,00)

(1) Basis points deviations from baseline for the loan rate
Source: BBVA Research and European Commission

Table 2
Transition and long-run effect of a 1pp increase in capital requirement in the eurozone to be **fulfilled in four years** (% deviation from baseline): BBVA Research vs. European Commission (in parenthesis)

	Year 1	Year 4	Year 8
GDP	-0,09	-0,20	-0,31
	(-0,05)	(-0,10)	(-0,15)
Investment	-0,70	-1,50	-1,99
	(-1,12)	(-1,23)	(-1,15)
Consumption	-0,01	-0,01	-0,09
	(0,18)	(0,13)	(0,03)
Loans	-0,39	-0,86	-1,28
	(-0,10)	(-0,40)	(-0,52)
Deposit	-0,70	-1,95	-2,41
Loans rate (1)	20,04	20,05	20,03
	(-1,00)	(10,49)	(12,00)

(1) Basis points deviations from baseline for the loan rate
Source: BBVA Research and European Commission

Governance: Steps towards more fiscal and economic integration, but with no mention of eurobonds

The summit final document is full of references to the governance reforms already approved by European institutions (legislative package, European semester, Euro plus pact), and to further commitments to enhance economic and fiscal coordination and integration. On the more substantive side, three key issues stand out from the summit:

1. The request to President Van Rompuy to prepare a "limited" Treaty reform by December as a basis to reach an agreement to be sanctioned by March 2012 is reiterated.
2. A special Commissioner will have the powers to monitor fiscal plans, while the Commission will be able to make proposals to countries all throughout the national budgetary process. This goes in line with proposals by Trichet and others towards a minister for fiscal affairs in Europe.
3. There is no mention on Eurobonds, which would constitute a clear signal that fiscal integration is pursued and would reduce pressures on sovereigns.

This implies that on the issue of governance and fiscal integration, the eurozone continues the German strategy of moving towards more integration through pressure on periphery countries, and that only once convergence is achieved in the fiscal and reform agenda the idea of Eurobonds could be raised. However, it cannot be discarded that the Van Rompuy recommendations follow the recent document by the Commission (Barroso proposals) that explicitly mentioned eurobonds ("stability bonds").

Overall: A positive step from the summit, but the jury is still out on the final outcomes

Although some of the more technical details still need to be determined, the recent summits have taken important steps in the right direction, but have not addressed definitely most of these points. First, private bondholders of Greek debt are asked to take a voluntary haircut of 50% –much higher than agreed in July– but doubts still linger about participation in the exchange and, even with full participation, about the solvency of Greece, which is still strongly conditional on measures that need to be taken in this country. The most recent events in Greece, with a referendum called by PM Papandreu (and afterwards called off), and the political uncertainties that have followed, raise further doubts on the ability of Greece to fulfil the required conditionality. Second, the EFSF will be leveraged as an insurance mechanism and complemented with outside investors (including possibly the IMF), but it is unlikely that any of the specificities of the functioning of the EFSF are ready before December. Thus, some time will be needed to ascertain its effectiveness vis-à-vis private investors, and hence the ECB will still be needed as a buyer-of-last-resort for sovereign debt, against the reticence of core European countries. Third, it is welcomed that more economic reforms are now on the agenda of some countries (notably Italy), and that as the help of the EFSF will be triggered by a request from countries in exchange of reform measures. At the same time, the recapitalization of the banking sector is being done inefficiently, compensating a moderate stress testing of banks' balance sheets –just using market prices for sovereign portfolios but not for so-called "legacy assets"– with a significant increase in capital requirements (9% core tier1 capital). This risks a sudden deleveraging of European banks, with negative effects on the supply of credit without cleaning the balance sheets of banks in the euro area. Moreover, a long-term liquidity provision mechanism is not in place yet, even though this is extremely important for banks to obtain financing. Finally, there have been some advances in European governance, but there is no clear roadmap to a fiscal union or Eurobonds, in our view a key element to make the monetary union more credible in the long run.

As we have mentioned in the past, partial solutions will probably just help prevent a further escalation of financial tensions, but they will remain elevated, increasing downside risks for economic activity in the eurozone. The agreements still leave doubts whether the necessary structure to prevent contagion and a systemic event from a Greek debt restructuring is in place: a large enough EFSF, with the ECB as debt-buyer-of-last-resort, and cleaned and recapitalized banks' balance sheets with access to financing. Without all of them, markets will continue to factor increased fatigue for reforms in Greece and fatigue for further bailouts in core countries, which increases the probability of a risk scenario of a credit crunch and a recession in Europe, with global spillovers.

3. Recent trends and projections

3.1 Eurozone

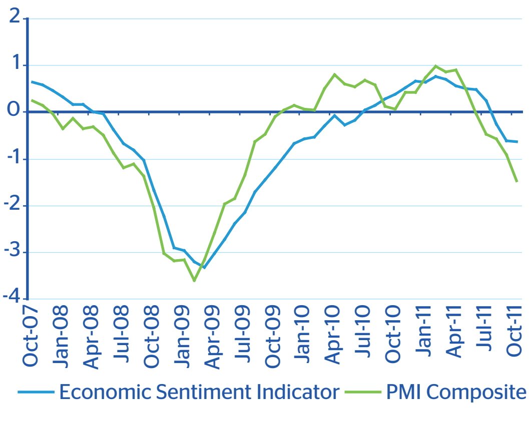
The eurozone recovery clearly lost momentum in Q2, while the short-term indicators suggest that growth could have remained flat over H2 2011

Eurozone GDP slowed significantly in Q2, showing that domestic demand continued to be weak, and failed to take over from exports as the driver of growth during the first half of the year. Hard data available for Q3 provided positive surprises, painting a less pessimistic outlook than soft indicators already released, that have slumped over Q3. Industrial production beat expectations, showing that industrial output has rebounded somewhat in Q3, while retail sales proved more resilient than anticipated. More worrying signs came from exports, as the support of global demand has continued to fade. Overall, these indicators suggest that economic growth in Q3 could have been similar to that observed in the previous quarter (0.2% q/q). Nevertheless, some downside risks anticipated three months ago, such as revival financial turmoil and lower momentum of global growth over Q3, have materialized and entered in our scenario.

Available data for Q4 is very limited, only confidence surveys for October, with sentiment from the European Commission neutral in contrast to pessimistic PMI figures (see Chart 13), which suggest that eurozone economy could have contracted slightly at the end of the year.

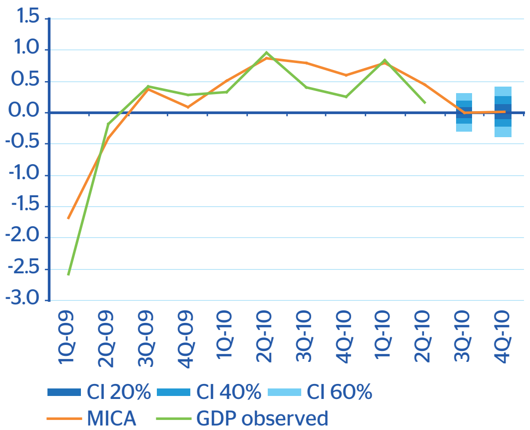
Overall, our short-term indicator model for the eurozone foresees flat growth over H2, in line with our baseline scenario (see Chart 14). Nevertheless, we see some upside risks for Q3, while risks are tilted on the downside for Q4. Uncertainty has increased, however, linked to the still unresolved European crisis that ended up sinking the economic agents' confidence, as well as the faster than anticipated deceleration of global demand. Nevertheless, unlike what was projected three months ago, the slowdown is expected to be broad based across countries, both peripheral and core member states.

Chart 13
Eurozone: Confidence data (standardized)



Source: European Commission, Markit Economics and BBVA Research

Chart 14
Eurozone: GDP growth and MICA model forecast (% q/q)

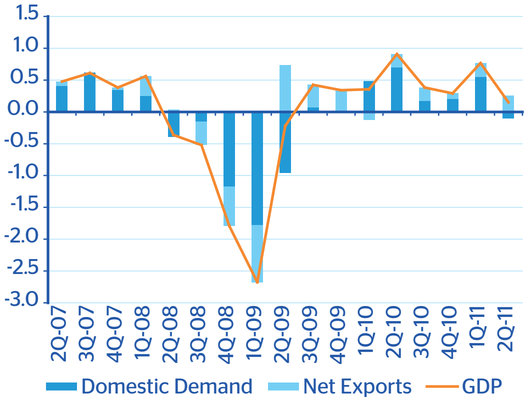


Source: BBVA Research

Net exports continue to support the recovery, despite the moderation in foreign demand. Fading external support could lead to a more pronounced slowdown in the periphery, although could be offset by a larger fall in imports

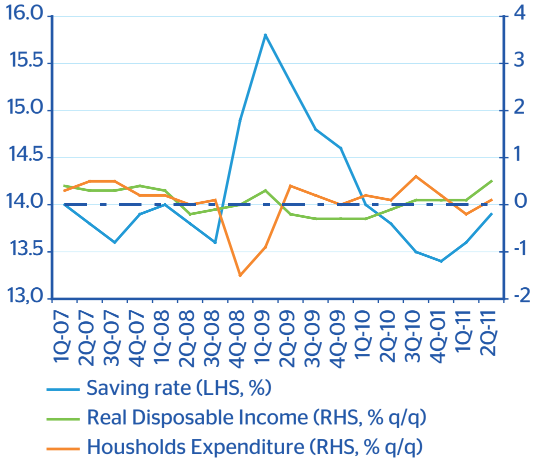
Despite the outcomes observed earlier this year, National Accounts data seemed to point to a more balanced growth with a larger contribution of domestic demand, while net exports remain as the key driver of economic growth (see Chart 15), especially in the periphery. This is despite the sharp moderation in exports growth since the second half of 2010, as the weakness in private demand was reflected in a further deceleration in imports. However, the loss of momentum in global growth now adds more uncertainty to the sustainability of the recovery, not only in the periphery but also in some core countries, as Germany. In particular, data available for Q3 suggest that net exports will again contribute positively to growth, although confidence surveys show a strong drop in orders from abroad. Overall, we see this pattern remaining over the second half of the year, thus returning to the typical growth pattern observed at the beginning of a recovery.

Chart 15
Quarterly GDP growth and contributions



Source: Eurostat and BBVA Research

Chart 16
Eurozone: Households saving rate, disposable income and expenditure



Source: Eurosat and BBVA

Domestic demand is not taking off, and is likely to remain weak in coming quarters

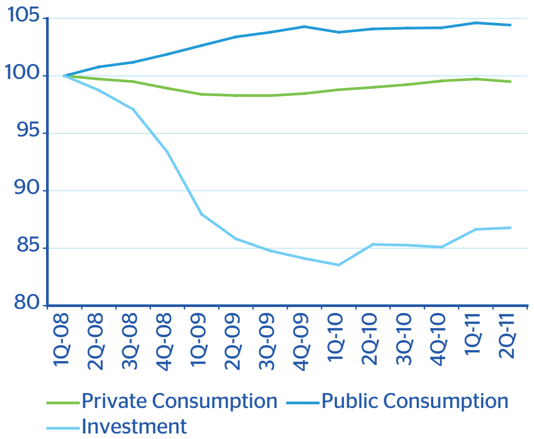
Drivers of private consumption continued to build up in recent months (see Chart 16), but they could have been offset by the fall in consumers' confidence linked to the European crisis. On the one hand, household disposable income in the eurozone increased markedly in Q2 (by 0.5% q/q after 0.1% q/q in previous quarters), as a consequence of higher increases in wages than in prices. Still, this increase in disposable income was not reflected in significantly higher household spending, as consumers raised their savings for precautionary reasons (to 13.9% in Q2 from 13.6% in Q1, as percentage of disposable income). In addition, although the labor market deterioration halted with the onset of the recovery in late 2009, the growth pace has not been enough to generate employment in a significant way, and the gloomy economic outlook does not anticipate an improvement in coming quarters. Moreover, strong fiscal consolidation to attain sound fiscal positions make economic agents anticipate tax increases that may impair their purchasing power. Finally, credit restrictions resulting from the need for banks to meet new capital requirements in June 2012 could dampen activity growth.

Notwithstanding this, "hard" data available for Q3 (retail sales up to August remained virtually flat over Q2 after contracting for three consecutive quarters) does not suggest a further fall in private consumption, but rather a stagnation or slight growth after the drop observed in Q2, mainly due to temporary factors in some countries, like Germany or France. As a result, we now expect a subdued private consumption next year, contributing timidly to economic growth. The divergence across member states is still 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 a stronger deterioration in labour markets.

Due to the need to attain sound public finances and ensure their sustainability, the contribution of public consumption to economic growth has moderated progressively since the start of the recovery, with a gradual fading of the fiscal stimulus implemented over the crisis. In particular, government spending contracted in Q2.

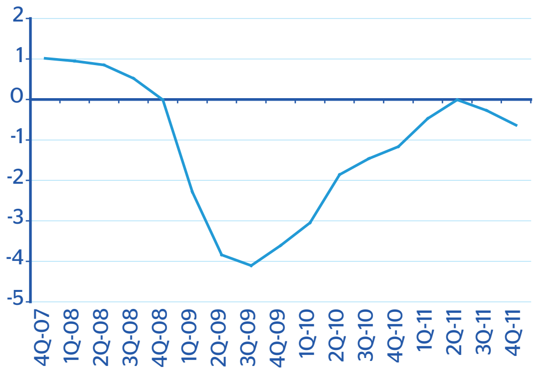
The cooling of global demand has been also reflected in the slowdown of investment in Q2, resulting in a sharp deterioration in business confidence that anticipate a moderate outlook for the remainder of the year. Capacity utilization has fallen back below its long-term average in recent quarters (see Chart 18), confirming that firms do not need further investment to meet demand expectations in the near future, although funding conditions have not significantly tightened and interest rates remain low. This is also reflected in the investment rate that fell again marginally in Q2 after increasing markedly last year. Nevertheless, aggregate investment remains burdened by the construction sector as a result or the bursting of the housing bubble in some member states, as well as the strong negative impact that fiscal adjustment is having on infrastructure. Investment in capital goods continues to benefit from still robust external demand, especially from emerging countries.

Chart 17
Eurozone: Domestic Demand Components (Index, 1Q 2008=100)



Source: Eurostat and BBVA Research

Chart 18
Eurozone: Current level of capacity utilization (standardized data)



Source: European Commission and BBVA Research

Forecasts for 2011 and 2012: Slower economic recovery, with risks strongly tilted to the downside

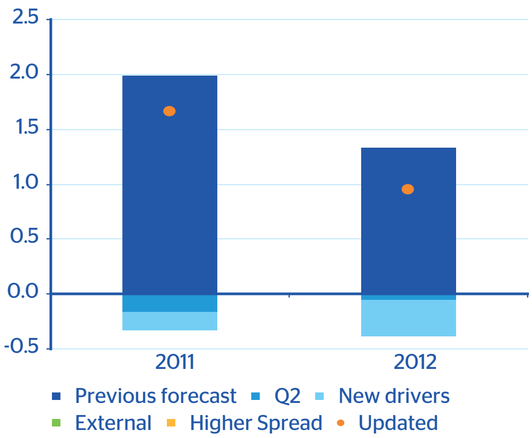
Although three months ago we already anticipated a much muted recovery than the average of previous upturns as a result of a deeper financial turmoil, some of the downside risks that we saw at that time have materialized. As a result, we revise downwards our baseline growth projection by 0.3pp in both 2011 and 2012 (see Chart 19), respectively, due to the spiraling of financial tensions and the sharp drop in confidence linked to sovereign debt crisis in the eurozone, but also to a larger slowdown in global demand as well as additional fiscal adjustments. Still, given recent developments in the monetary union, it is important to note that our baseline scenario is markedly determined by the assumption that the European authorities are able to prevent and interrupt the negative feedback loops between sovereign debt crisis along with the fragility of banking system and slowing growth.

Under this assumption, the annual average growth in 2011 is clearly determined by the strong rebound in activity, larger than expected, in Q1, while growth in Q2 was somewhat lower than anticipated and we have revised downwards the quarterly profile for H2 2011, as we are expecting now an economic stagnation. As a result, the eurozone GDP will grow by around 1.7% in 2011, 0.3pp lower than estimate three months ago. We now expect a more subdued private demand, both consumption and investment, combined with a more pronounced slowing in public consumption, resulting in a lower contribution of domestic demand (around 1pp). The remainder 0.7pp of growth should be added by net exports.

For 2012, the GDP growth should slow to around 1%, slightly more than anticipated (-0.3pp). Underlying this slowdown is the abrupt fall in confidence as well as additional fiscal adjustments and a lower momentum of global demand, resulting in lower contribution of both domestic demand and net exports. We expect private consumption and investment to slow further, while public consumption will remain virtually flat in 2012. The lower domestic demand will be reflected significantly in imports, so that net exports should contribute positively to growth.

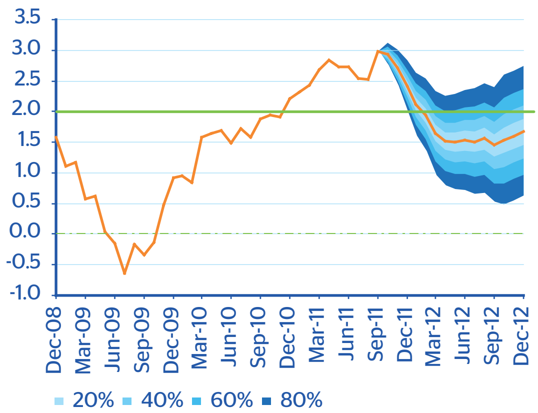
As noted above, the likelihood of a quick and final resolution of the European crisis is decreasing, and thus increasing the risk of contagion beyond the periphery, resulting in an escalation of financial strains and a collapse of economic agents' confidence. On the other hand, although the results of the October summit are in the right direction, they can also lead to further factors that dampen the recovery, including the possibility of a credit restriction resulting from the recapitalization of the banking system (although the negative impact is estimated to be moderate and will probably be offset by increasing confidence and the reopening funding markets, see Box 2). Hence, we can not rule out that the eurozone economy could enter into a more negative scenario, contracting again in the last quarter of the year and possibly at the beginning of 2012. If we add the risk of a disorderly resolution of Greece's troubles, we can not exclude a contraction of GDP next year.

Chart 19
Eurozone: GDP (Annual average growth, %)



Source: BBVA Research

Chart 20
Eurozone: HICP (% y/y)



Source: Eurostat and BBVA Research

Inflation moderated only marginally in Q3, but inflationary pressures are fading

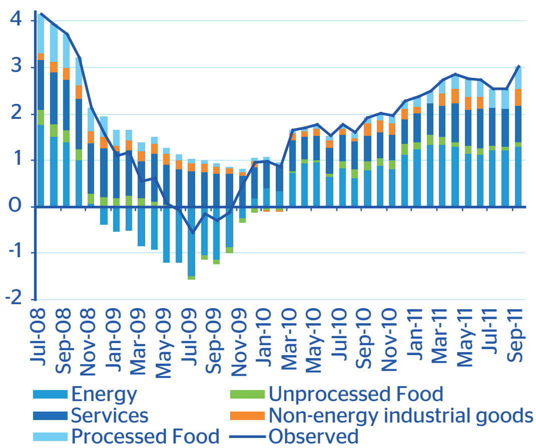
The inflation performance over Q3, especially that of its core component, has been characterised by increased volatility as a result of the methodological changes introduced in the treatment of seasonal products. In particular, annual inflation slowed more than expected at the beginning of the quarter, due to the larger impact of the summer sales resulting from this change, but it was offset partly by the strong rebound observed in prices, mainly of non-energy industrial goods, in September. In Q3 as a whole, inflation has slowed by about 0.1pp to 2.7% y/y from the previous quarter, slightly below our baseline scenario. Regarding other components, inflation in both energy and services remained broadly stable in Q3, while the acceleration observed in the growth of prices of processed food (driven by higher prices of tobacco) was more than offset by the slowdown in inflation of fresh food. Overall, the main determinant of the high annual inflation rates remains high energy prices, accounting for almost half the annual inflation figures (see Chart 21). In addition, confidence surveys continue to reflect a clear fading of the inflationary pressures, mainly resulting from the weakness of demand.

Across large member states, the inflation stabilization in Q3 was widespread after the sharp acceleration observed over the first half of the year, although with some differences. While in France and Germany headline inflation rose marginally by 0.1pp, it slowed by around 0.3pp in Italy and in Spain, probably reflecting weaker domestic demand. However, in the case of Spain and Portugal, the sharp slowdown in inflation also reflects a base effect following tax hikes last year. Regarding core inflation, it increased slightly only in Germany (0.1pp), although inflationary pressures are also declining and there have been no second round effects (see Chart 22).

Looking forward, we continue to see inflation to moderate by the end of the year (see Chart 20), driven by favourable base effects in energy prices along with the weakness of domestic demand, reverting below the ECB target by the end of Q1 2012. Due to the slight downward innovation observed in Q3, we now expect headline inflation to remain well above the ECB's inflation target in 2011 as whole, at around 2.6%, 0.1pp lower than expected three months ago. For 2012, we see inflation remaining clearly below 2% as from Q2, resulting in an annual average growth around 1.6%, 0.2pp lower than our previous projection due to fading inflationary pressures. Regarding core inflation, we expect it to hover around 1.8%-1.9% y/y for the remainder of 2011, moderating somewhat afterwards, resulting in an annual average of around 1.7% in both 2011 and 2012.

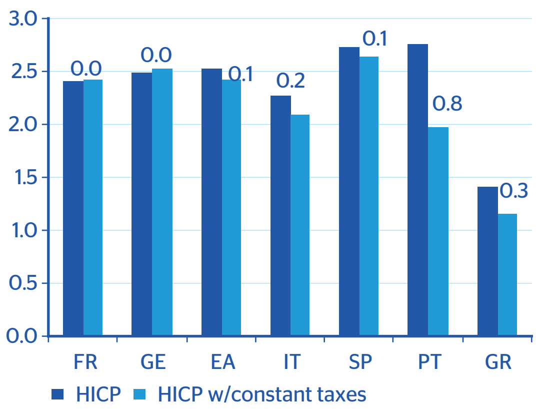
Risks to our inflation forecast are broadly balanced. We continue to see upside risks mainly from potential tax increases and higher administered prices implemented to improve public finances, and a further increase in commodity prices. On the downside, a deceleration of private demand from a sharp decline in consumers' confidence would weigh on inflation. On the other hand, we stress the still high uncertainty around the forecast of industrial good inflation this year, given the limited information to model the change of seasonality of the series.

Chart 21
Eurozone: Annual HICP inflation rate. Contribution by components (pp)



Source: Eurostat and BBVA Research

Chart 22
HICP by countries in August 2011 (% y/y, values are differences in pp between rates)



Source: Eurostat and BBVA Research

Box 3. ECB: Spinning to a pre-emptive approach

At the first meeting of the Governing Council chaired by Mr. Draghi in November, the ECB surprised with a rate cut of 0.25%, in adoption of a pre-emptive policy, in order to reverse the gloomy economic prospects in the euro area in a context of disappearing inflation concerns. At the same time it was decided that no changes would apply to the Securities Market Programme (SMP). These measures came after launching strong signals that the ECB would do whatever necessary to sustain bank funding at the last meeting chaired by Mr. Trichet's in October.

Tentative signs of a more pragmatic monetary policy

A non-anticipated rate cut came along with the new president, Mario Draghi, a cut surely not expected to arrive so soon. The refinance rate now stands at 1.25%, with the corridor unchanged to +/- 75bp. The decision was taken unanimously, on concerns about the materialization of downside risks to economic activity coupled by deteriorated sentiment as shown in October confidence surveys. It appears as if more weight is now put on economic activity, rather than price stability. It is too early to know if this change of view responds exclusively to the new incoming data or if it reflects as well a new attitude by the ECB. Provided that ECB will maintain its pre-emptive policy, another rate cut is anticipated for as early as December.

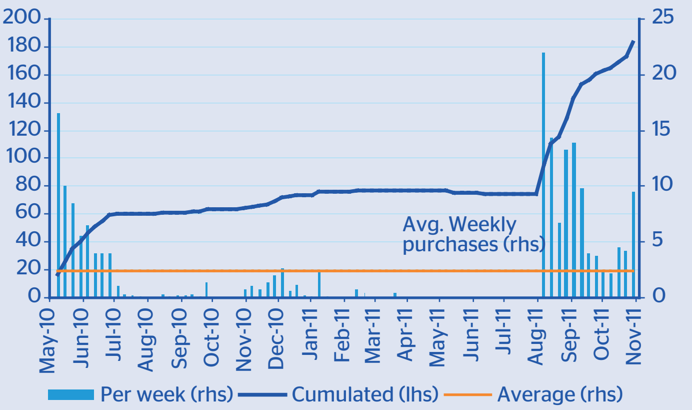
The policy on the SMP of public and private debt securities was left unaltered. Therefore, the SMP is still viewed as a temporary program in nature, limited in amount and justified on the basis of addressing the tensions in certain market segments to restore monetary transmission channels. Nevertheless, Mr Draghi stressed that the ECB as lender of last resort "is not really the remit role of the ECB". We expect the program to continue being operational for as long as needed, without any time restrictions.

Focus on helping eurozone bank liquidity

The provision of liquidity has attained increased importance, amid evidence of a mal-functioned money market. Therefore, ECB wants to ensure that the markets are liquid enough and that access to funding for banks and to credit for all other economic agents is not a concern.

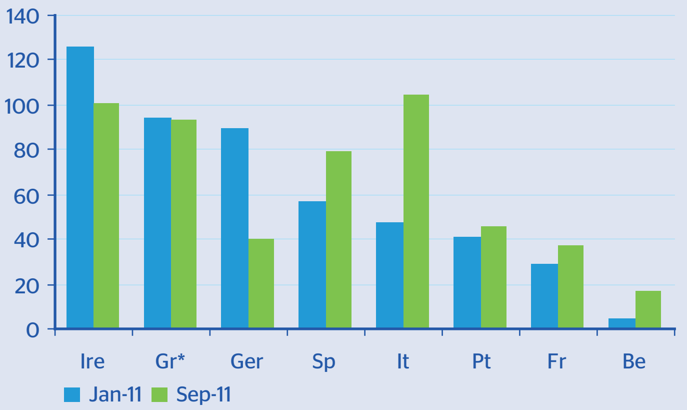
The main objective of the October meeting was to provide further liquidity measures aimed at easing strains in bank funding markets. The ECB announced it would conduct two LTROs: a 12 month one in October[4] and a 13 months one in December. In addition, the central bank will continue to offer unlimited short-term liquidity[5] for as long as necessary and at least until July next year. Lastly, the ECB also announced a new covered bond purchase programme (CBPP2) to buy bonds issued by banks and backed by collateral. Purchases will amount to €40bn, they will be conducted in primary and secondary markets starting in November 2011 and will be fully implemented by October 2012. This measure aims at easing liquidity strains, as the covered bond market has been closed in the past few months.

Chart 23
ECB: sovereign bond purchase program



Source: ECB and BBVA Research

Chart 24
ECB: use of MROs and LTROs (bn EUR)



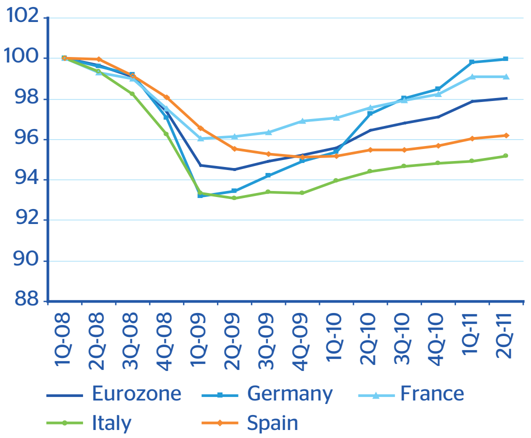
*Grece September data= August data
Source: ECB and BBVA Research

4: The ECB allotted EUR56.93 billion in the 371-day auction with 181 bidders
5: One-week, and one-month MROS, and 3-month LTROS

3.2 Member States: A closer view

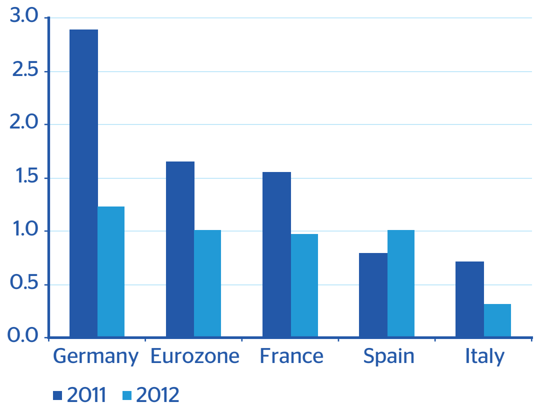
The strong drop in confidence has been widespread and has affected all member states, proving that no country is immune to the deep crisis in Europe and remaining below the theoretical levels that separate the recession from the expansionary territory, although slightly less in Germany than in other countries. In this sense, the decoupling between core and periphery is expected to linger in the future, but at a much lower extent than in the past two years (see Chart 25 and 26).

Chart 25
GDP by countries (Index, 1Q 2008=100)



Source: Eurostat and BBVA Research

Chart 26
GDP forecasts by countries (Average annual growth, %)



Source: Eurostat and BBVA Research

Germany: More vulnerable than anticipated. Moderate growth in 2012

Germany is losing momentum, as it is not immune to peripheral challenges. In view of an intensified rather than resolved European crisis, consumer and business confidence is weakening, while slowing global demand is also weighing on strong exports support. The industrial sector is contracting after a long period of expansion, as demand from new orders is shrinking. As a result, the German economy remained marginally on the growing path in the second quarter, against more optimistic expectations, after the strong performance observed during Q1. The slowdown can be attributed to a sharp fall in private consumption, amid increased uncertainty reflected in weakening consumers´ confidence, which together with construction drove growth down. On the external sector, the withdrawal from nuclear energy production had a notable effect, as the exports of electricity have dropped to a great extend and imports increased in order to meet domestic demand and restocking, thus net exports contributed negatively to growth. In contrast, positive contributions were made from inventories and investment. Investment increased, driven by the equipment component, while construction fell.

The favorable labor market developments observed in Q2 remained in place during the third quarter, though less pronouncedly, with the unemployment rate steady at 6%, much lower than the eurozone average, which could at least partially offset the impact of uncertainty on private consumption. In addition, private demand could bounce back in the coming quarters supported by falling prices. Industrial production, which is particularly important in Germany, made a strong start in Q3, mainly attributed to temporary factors, which was followed by a contraction, in line with the declining trend in new orders, which deteriorates the outlook for the industry. PMI surveys point to a rebound in services for the rest of the year, after contracting in Q2, and to stronger deterioration in manufacturing for the next quarter. Business confidence, which started falling during the second quarter, has been weakening further throughout Q3, leaving a slightly pessimistic message, though better than the one received from PMI indicators.

On the fiscal side, final figures show the 2010 deficit is finally at -4.3%, one point above the previous estimate due to the new information on re-evaluation of assets transferred from the

Hypo Real Estate bank to FMS Wertmanagement, a winding up agency created with the aim of maximising the asset portfolio transferred. Debt in 2010 stands at 81.7% of GDP, after the downward revision by €55bn. The good performance in activity and tax collection is likely to exceed estimates during to 2011, and makes it probable that this year deficit target set at -2.5% will be attained or even improved.

Lowwer growth in the coming quarters will be driven by domestic demand, as exports are weakening in the second half of the year, while imports continue growing. Overall activity is expected to improve slightly in Q3 followed by stagnation or moderate contraction in the last quarter of the year, after a substantial drop in sentiment and in incoming orders. In view of developments mainly related to the financial crisis, the fall in economic agents' confidence and continuing slowing global demand, the forecasts for economic growth were revised downwards and we now expect a deceleration of growth from 2.9% in 2011 to 1.2% in 2012, against previous estimates of 3.3% and 1.8% respectively. The predicted modest expansion in 2012 can be explained mainly by lower export growth and weaker domestic demand. As mentioned for the eurozone as a whole, this scenario is dependent on the improvement of the financial outlook in Europe

On prices, both headline and core inflation increased marginally in Q3, interrupting the sharp acceleration observed over the first half of the year and remaining slightly below the eurozone average. Looking forward, we expect inflation to moderate significantly by end year, averaging an annual inflation rate of 2.4% in 2011, slowing further over next year to 1.6%. According to confidence surveys, inflationary pressures are fading, while a gloomier economic outlook should dispel doubts about the possibility of second round effects.

France: Lower growth in 2012, as the support of domestic demand fades

The economic performance of France in Q2 could not keep up with the strong growth observed at the beginning of the year, resulting in flat output. The recent stagnation can be attributed to extraordinary factors such as the withdrawal of the car-scrapping premium and uneven growth contributions from inventories. Adjusting for these factors, the decline in growth would have been softer. Private consumption contributed negatively to growth, and although is expected to bounce back somewhat in coming quarters, households' spending is likely to remain more muted than observed at the beginning of the year, as uncertainty related to the debt crisis is prevalent and unemployment is edging up. Investment was slightly up in Q2, but it is expected to worsen, amid unusually high uncertainty, despite lowered interest rates and moderate fiscal consolidation. Business and consumer confidence are shrinking, with negative effects weighing on domestic demand. A factor that is seen improving in the near future is net exports, as lower domestic demand is expected to drive imports down, while exports continue increasing.

Industrial output has been positive recently, after a sharp fall in June, whereas new orders slowed down, thus deteriorating the outlook of the sector, as lower demand will eventually drive activity down. As for the eurozone as a whole, PMI surveys indicate for the end of the third quarter and signal for the Q4 that activity in manufacturing is declining, though in a decreasing pace, while services show a pattern of volatility, with contraction expected as early as October.

At present, the main concern for France is related, as elsewhere, to the European debt crisis, as it is the country most exposed to Greek debt and it has received a warning from a rating agency on an eventual cut of its triple A rating. Under this warning, a new factor might come into play as a driver, namely a supplementary budget seen necessary in order to convince agencies and investors that its public finances are sound.

The fiscal situation is therefore crucial. France has targeted a deficit of -5.8% of GDP in 2011 and -4.6% in 2012, after -7.1% in 2010. Due to worse than expected growth and in order to meet the target this year, the government announced extraordinary measures to raise revenues during the year by €4bn. For 2012, further measures amounting to €11bn have already been identified, but further ones, such as VAT changes, are being discussed in order to overcome the shortfall generated by the downward revision of growth, in a context of presidential and general elections by mid next year. For next year, we expect de deficit to be at -4.9% of GDP. Debt for 2010 was revised upwards and now stands at 82.3% due to GDP revisions, and is expected to attain 85.2% this year.

The very subdued economic performance of the second half of this year will lead to an average growth of 1.6% for the full year, and with fiscal restraint, growth in 2012 is expected to be of 1%, down from our previous projections of 1.9% and 1.5% for both years.

On prices, unlike what was observed in the eurozone as whole, both headline and core inflation remained relatively stable, accelerating slightly in the first half of the year but remaining clearly below the eurozone average. As the base effect is lower, we do not expect a moderation in inflation as intense as in other member states in last quarter. Overall, for 2011 as a whole we expect annual headline inflation to be at arounf 2.2%, decelerating over 2012 to average at 1.5%, driven by lower inflationary pressures resulting from the weakening of domestic demand.

Italy: Fiscal consolidation, together with a faltering recovery

In Italy, some improvement was observed in Q2 after a long period of sluggishness, but recent developments inside and outside the country point to a relapse in activity for the second half of the year with GDP remaining flat over the period at best, or even contracting. In contrast to other countries of the eurozone, Q2 for Italy was stronger than Q1, but the fiscal consolidation currently taking place is slowing the recovery process. Consumption, private and public, and investment contributed positively to growth, but only marginally. The weak conditions in the labor market, with unemployment above its long term average, and the inflationary pressures are not favouring domestic demand, as the immediate consequence of restrained real disposable income will be dampening private consumption. Investments are not seen improving either. The main push in Q2 was given by exports, and the main driver of growth, accompanied by negative contribution of imports, but it is seen to moderate, as global demand is weakening.

Italian finances have been under scrutiny since the summer while the country witnessed a continuous increase in sovereign spreads. As a reaction to market pressures, the Italian government announced in early August its commitment to achieve a budget balance by 2013, one year earlier than previously expected. Although fiscal developments in 2011 have been broadly in line with targets that envisaged a decline in the deficit by -0.5 pp of GDP (from -4.6% to -3.9% of GDP) the increase in interest rates for a highly indebted public sector (debt stands at 119% of GDP) implies a risk of debt spiralling up if these stress levels are not reduced through the implementation of fiscal and structural reforms. The detailed measures announced in September, totalling 4 pp of GDP and covering three years, include: 1) An increase of VAT by 1pp up to 21%. 2) A pension reform that brings forward by two years (to 2014) the increase in retirement age for both men and women in the private sector. The retirement age for women is currently set at 60 and will be progressively raised to 67 by 2026. 3) A solidarity tax of 3% for incomes above 500.000 euros. A key element for consolidating the deficit in coming years is the "delega fiscale", a provision whereby extra savings will have to be identified by the state and regional governments in the coming two years. If these are not identified, a generalized cut in tax subsidies for many different items would automatically be triggered.

These measures have failed to convince markets that see the need to approve also structural reforms to reinforce growth potential, which is low in Italy and is seen as a major risk for sustainability. In this respect, the government made a list of further reforms, presented at the October EU council and G20 summits that include incentives for employment and infrastructure investment, a plead to reform professional services, a target for privatizing public assets at state and local level and a commitment to introduce a budget law in the constitution. But the lack of definition of some of these measures and the difficult political situation prevalent at the closing date of this publication has resulted in a failure to reduce spreads of Italian bonds. More definition and, above all, implementation will probably be required to reduce market pressure on the Italian sovereign.

The main risk and challenge for Italy is to put up with the contagion from the crisis in the periphery, which has already raised its borrowing costs, and to implement the fiscal and structural reforms that have been recently announced. This announcement was not considered detailed enough in recent EU and G20 summits, and Italy has been put under the monitoring of the European Commission and the IMF. Confidence has been fading over the last months and it is not expected to improve any time soon. Thus, for the medium term, activity is seen growing only modestly by 0.7% in 2011 and 0.3% in 2012, driven by only minor net exports support, against previous projections of 0.8% and 0.7%, respectively.

Inflation accelerated suddenly in Q2, but mainly due to the methodological change on seasonality treatment that led to a strong increase in prices of non-energy industrial goods, especially. This change has introduced much more volatility in prices since then, as observed also in Q3, but the average inflation in that quarter slowed, especially for core prices, and thus inflation is returning to the eurozone average. We expect annual inflation to average at 2.6%, slowing at a more moderate pace than in other member states in coming months. As a result, Italian annual inflation should remain slightly above the average in the eurozone, around 0.2pp at 1.8%. In addition, there are upside risks to our forecasts, as the need to clean up public accounts may lead increases in both taxes and administered prices.

Spain: Low growth with downward bias due to higher uncertainty

The increased uncertainty about the global economic outlook has also negatively affected the expectations about the recovery in Spain. In addition to the realization of some global risks, as the slowdown in global demand and increased financial strains, the adjustment of economic imbalances continues to proceed in the Spanish economy, boosted by the fiscal consolidation in some sectors. The incipient recovery in output has not been able to generate employment, and combined with the ongoing declining in households' disposable income weigh on private consumption. Regarding investment, the adjustment has intensified as a result of the completion of tax incentives and ongoing government deficit reduction. In contrast, the strong exports performance continues to support the investment in equipment. Net exports are the main driver of growth, preventing negative growth rates, although data for Q3 point to stagnation.

Looking forward, confidence indicators and financial strains anticipate a stagnation in the eurozone as a whole, which would negatively affect the hitherto strong growth of Spanish exports. In addition, there are some idiosyncratic risks. First, increasing Spanish spread over the past three months and expectations of a slow narrowing to those levels determined by fundamentals could detract from growth in 2012. Second, uncertainty surrounding economic policy, especially about the resolution of the European crisis, could have a negative impact on private consumption and investment. Third, the increasing likelihood of fiscal deviation in autonomous regions along with potential downward growth revisions could trigger a stronger fiscal adjustment, than anticipated three months ago, over H2 2011 and throughout 2012 to meet fiscal targets. On the positive side, a more accommodative ECB monetary policy could be positive for the private sector, but probably insufficient to offset the effect resulting from higher uncertainty.

Regarding the fiscal situation, after the strong rise in public consumption observed in Q1, it was sharply corrected in Q2. The public spending fall has primarily been observed at the central government, which maintains a constant fiscal consolidation effort and to a lesser extent in the autonomous regions, bringing the cumulated total deficit at -3.8% of GDP at the end of Q2. However, despite that, budget execution in autonomies in that quarter showed an incipient decrease in regional spending, the sustained decline in revenues has led to a cumulated deficit over H1 2011 of 1.2% of GDP, only one tenth below the year-end target. By contrast, recent data show that fiscal consolidation at central level proceeds, with an accumulated deficit of 3.4% of GDP in September, 0.8pp below than the deficit printed last year. As a result, central administration is expected to close the year comfortably met its target of -4.8%, which will offset some expected slippage in the autonomous regions and social security. Notwithstanding, the total public deficit in 2011 is likely to be well above 6% of GDP, unless additional measures are announced.

Summing up, the Spanish economic growth will remain low in the forecast horizon, with net exports as the main driver of GDP growth in the medium term. In particular, the pace of the recovery has slowed recently, confirming that GDP growth in 2011 will be marginally lower than projected three months ago (0.8% vs. 0.9%). We expect quarterly GDP growth to remain positive, albeit moderate, over next year, resulting also in a lower annual growth than anticipated (1.0% vs. 1.3%). Finally, the absence of definitive measures at both European and domestic level, that completely dispel persistent doubts about governance and growth capacity and job creation in the Spanish economy, have raised the probability of a more negative scenario that the one presented in this report. (For more details, see Spain Economic Outlook. Fourth quarter 2011).

On price development, inflation continued to show a gradual slowdown in Q3 to reach 3% y/y in early Q4, and thus the ongoing decelerating path observed in Q2 proceeds. Recent data confirm that high Spanish inflation rates, in the absence of inflationary pressures, were coming from specific factors (high commodity prices and VAT hikes) which do not trigger a loss of price competitiveness. Therefore, the inflation differential with respect to the eurozone was, on average, 0.7pp in H1 2011, falling to 0.2pp in Q3 (0,0pp in September). In contrast, considering inflation rate at constant rates, this differential was favourable to Spain since H2 2010. Overall, since the upward pressures on consumer prices resulting from the above factors will end up being diluted in the remainder of the year, and combined with no upward demand pressures, headline inflation will continue slowing in the last quarter of the year, registering an average annual inflation rate of 3.1% en 2011 and 1.2% en 2012.

Box 4. Portugal: Fiscal consolidation implies a recession this year and next

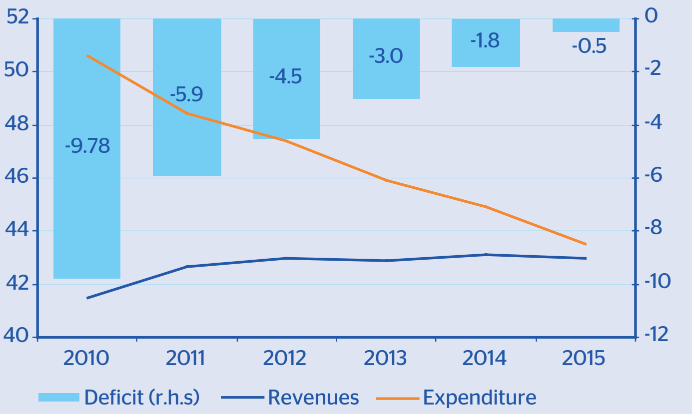
Fiscal developments have been at the center stage in Portugal since the summer. The first review led by the troika and released by mid-August showed its satisfaction with the performance of the Portuguese economy, but highlighted rising concerns on its ability to meet this year's target. This led to a sequence of announcements of additional saving measures to cover the impact of (1) the recognition of deficit and debt misreporting in the region of Madeira and (2) a worse than expected cyclical behaviour. Activity has proved to be more resilient than expected to the fiscal retrenchment during the first semester of 2011. However, the prospects are becoming gloomier for the remainder of the year as exports, the main source of counteracting the fall in domestic demand, will slowdown as economic activity decays in its main economic trading partners. This leads again to the need to maintain the reform agenda, which up to now has been progressing positively.

Fiscal deficit for 2011 is expected to stay on track thanks to additional measures, but implementation challenges for 2012 remain

The government is strongly committed with fiscal targets with the objective to reach a -5.9% deficit in 2011, -4.5% in 2012 and -3% by 2013. By the end of August the government announced additional measures to cover this year's budget slippages of around 1.5% of GDP. August measures were positive but temporary, and therefore they will require further tightening than expected in 2012. The measures taken for 2011 include higher taxes on personal income of temporary nature (0.5% of GDP); higher VAT rates for gas and electricity (measures projected for 2012 and brought forward to 2011, by 0.1% of GDP); sale of concessions (0.4% of GDP); and acceleration of planned transfer of bank's pension funds (0.6%). Due to misreporting on Madeira accounts, final figures for 2010 have been revised, with the deficit increased from an initial 9.1% to 9.8%, while the debt now stands at 93.3% of GDP.

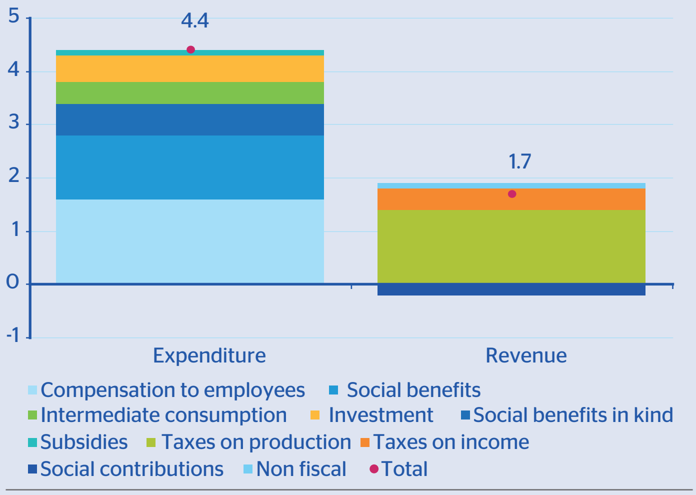
Fiscal figures from budget execution data at the state level up to September show an improvement with respect to last year. The Portuguese state government posted a deficit of €-4.6bn, improving by €2.8bn from a previous €-9.1bn posted in the same period last year. A mechanical extrapolation up to the end of the year, assuming that the consolidation path will mimic last year's performance shows that the Portuguese government in principle will be able to meet the €-9.1bn target by the end of 2011.

Chart 27
Portugal: General Government Deficit Target



Source: Portuguesse Ministry of Finance and BBVA Research

Chart 28
Portugal: 2012 expenditure-revenue measures



Source: Portuguesse Ministry of Finance and BBVA Research

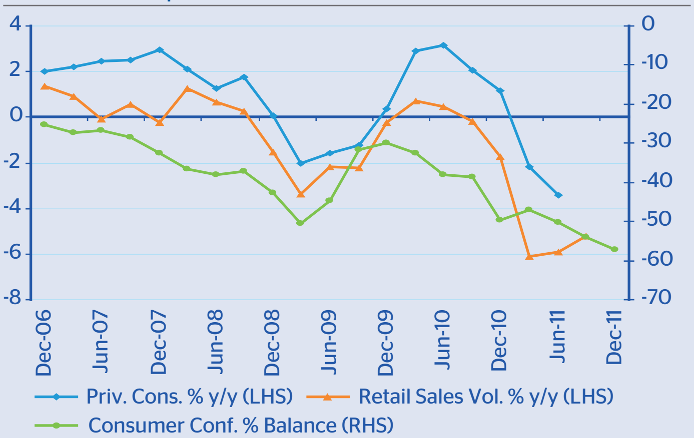
In October, the details of the State budget for 2012 were disclosed and are expected to be approved in Parliament by the 29th of November. The consolidation package for 2012 accounts for savings of 6. 1 pp of GDP, tilted towards spending. Saving measures make up for 4.4 pp of GDP, while revenues are expected to increase by 1.7 pp of GDP. The Government has revised substantially downwards the growth projections for 2012, from -1.8% in August to -2.8%, implying a worse than expected cyclical behaviour. Expenditure measures include cuts in the compensation to employees (1.6% of GDP) through the elimination of the Christmas extraordinary payments and the reduction of social benefits both monetary (1.2%) and in kind (0.6%). Intermediate consumption and investment will also be reduced by 0.4% and 0.5%, respectively. Revenue measures include the restructuring of VAT taxes, were some goods will be classified under the top rate currently set at 23%, changes in income taxation and restrictions on fiscal subsidies applied to companies. The government also plans to implement substantial cuts in both health care and education. At the same time, it will allow private sector working hours to be increased by 30 minutes per day for the next two years and will adjust the holiday calendar.

Privatization plans remain as laid out in the EU-IMF programme (20% reduction in 94 public companies). BNP has been already privatized, while EDP should follow before end-year. Additional measures to reduce the government debt burden are being taken. All in all, we expect debt (including the impact from recapitalizations) to continue increasing in 2012 and to stabilize in 2013, remaining above 100% up to 2015.

Activity contraction should lead to the correction of imbalances

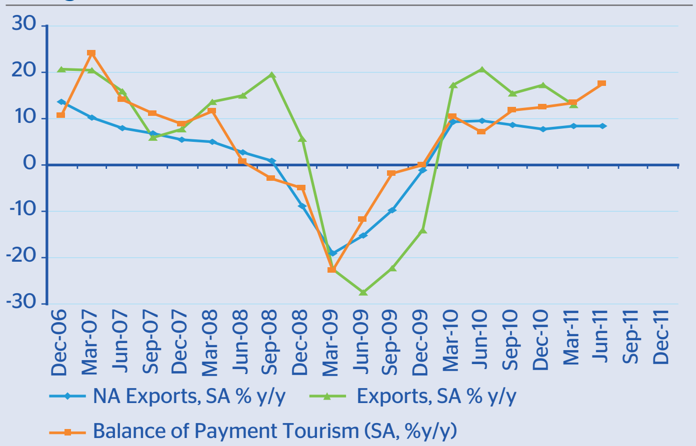
Economic activity is proving somewhat more resilient than initially expected taking into account the sizeable fiscal adjustment implemented. GDP growth stagnated in Q2, contrary to the expectation of a major decline. Nevertheless, recent data suggest further contraction in the second half of the year. Domestic demand will continue to dampen growth, as the deleveraging process and high levels of unemployment will affect consumption, consumer confidence is at minimum levels and business climate is falling. At the same time, the fiscal consolidation retrenchment will impact further on public consumption and public investment. The main growth driver should continue to be external demand; however, the deterioration on economic prospects from its main trading partners leads to a downward revision to this source of growth. Up to now, the relatively good performance of the industrial sector was mainly supported by external demand, but investment has fallen strongly in recent quarters.

Chart 29
**Portugal:
Private consumption, retail sales and consumer confidence**



Source: INE and BBVA Research

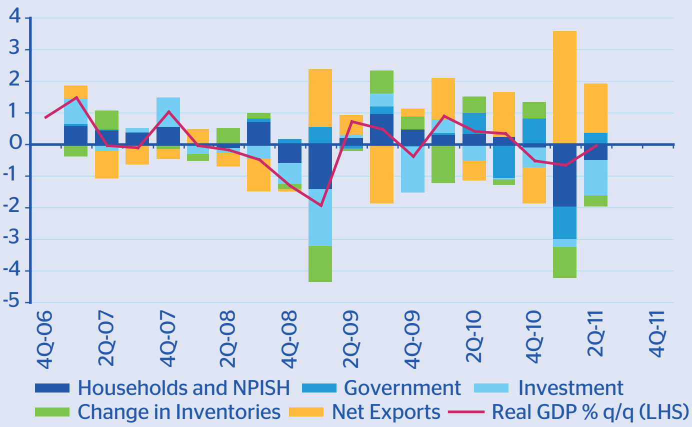
Chart 30
Portugal: External sector



Source: INE and BBVA Research

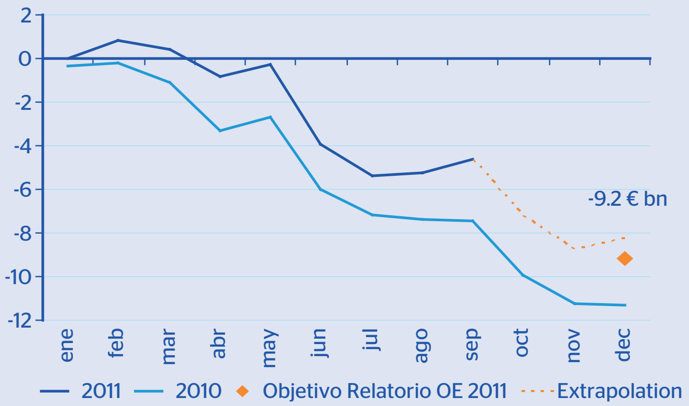
In view of latest domestic and external developments we revise our projections. We foresee a contraction of -1.4% in 2011 (slightly revised upwards from the previous -1.6% thanks to the positive base effect in Q2) and -1.5% for 2012 (revised downwards from -1.1% previously on account of a gloomier European environment). There will be a sharp drop in consumption and investment and worse than expected performance of the external sector. The economy will be in recession, but our view continues to be less negative than the one expected by government, IMF and EU. The main drags will be the impact on domestic demand of the fiscal consolidation and the need to deleverage in the private sector that will lead primarily to an increase in savings and in modest way a decline in investment so as to reduce the still large current account deficit. As for prices, the significant acceleration in both headline and core inflation recorded at the beginning of the year halted in Q2. There are signs of sizeable second round effects from higher oil prices. Prices are expected to increase on average in 2011 up to 3.4% mainly due to VAT increases and energy prices; however, excluding taxes, the rate of inflation stands by 1.5 pp below that level.

Chart 31
Portugal, GDP growth and contributions



Source: INE and BBVA Research

Chart 32
Budget execution (update profile)



Source: INE and BBVA Research

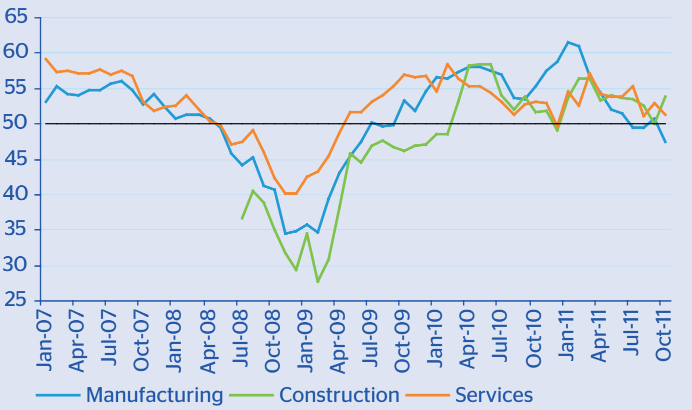
Box 5. United Kingdom: Sluggish growth leads the Bank of England to take further action

The deterioration of the global outlook, the lengthy eurozone crisis and the impact of fiscal consolidation is affecting UK economic activity harder than initially foreseen. This has led to a shift from the Bank of England strategy, as in its October meeting it decided to increase, earlier than expected, the target of asset purchases by 75 bn GBP with the aim to stimulate economic activity, and although the monetary authority has been upbeat with regard its potential benefits, there are doubts on the effectiveness of this type of measure. Inflation remains high but it is expected to revert next year to close to the target as the impact of the VAT and oil prices increase fades away. Nevertheless, inflation will continue to be closely monitored in coming months as there are concerns on the impact further quantitative easing may have on prices. On the fiscal front, the implementation of this year's budget is on track, although its impact on growth is probably being higher than initially expected.

Economic activity in 2011 remains weak...

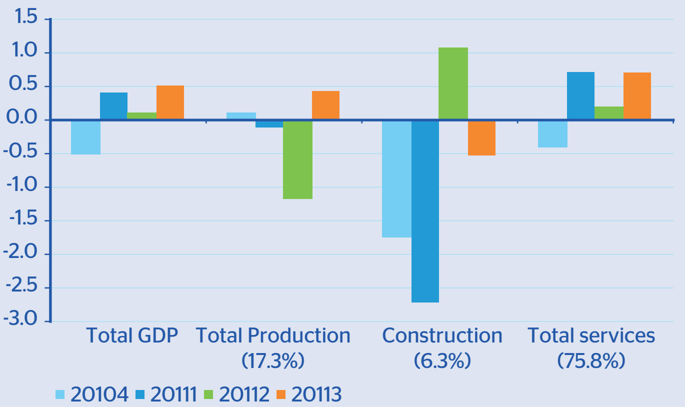
By mid October, the new national accounts were published with data revisions due to a series of changes in methodology and coverage that showed that the recession had been more pronounced than originally thought. For a more recent time frame, GDP data for Q2 was revised downwards to a weak 0.1%q/q, while the estimate of Q3 GDP turned out to be above expectations with growth at 0.5% q/q. The increase was led by the service sector, which accounts for ¾ of the index, but the increase is also due to base effects, as Q2 was affected by negative temporary factors (Japan's Tsunami and an unforeseen bank holiday). Prospects for the end of the year are negative, according to both soft and hard leading indicators, as volatility in financial markets and the global outlook have worsened. Not many indicators for Q4 are currently available, but soft indicators such as PMIs point to potential risks, in spite of the good performance of construction. Manufacturing PMI moved in October to contraction territory, falling to a level of 47.4, after a positive revised reading of 50.8 in September, while services PMI remained in the expansion area for a small margin, but subcomponents related to activity in coming months are gloomier as domestic and export orders are declining. Business confidence is also plunging in the aftermath of this summer financial turmoil.

Chart 33
UK: Manufacturing, services and construction PMIs



Source: Markit

Chart 34
UK: GDP Expenditure



Source: ONS and BBVA Research

... and it is expected to pick-up next year but at a slow pace

In view of weak leading indicators, we have revised downwards our projections. We now expect growth to be at 0.9% in 2011 and 1.3% in 2012 (-0.2 pp lower than expected in both years three months ago). The main drivers for the downward revision are the weakening momentum for the remainder of the year, together with higher risks in major trading partners, strains in bank funding markets and the ongoing fiscal consolidation, which is having a somewhat higher impact on consumption than expected.

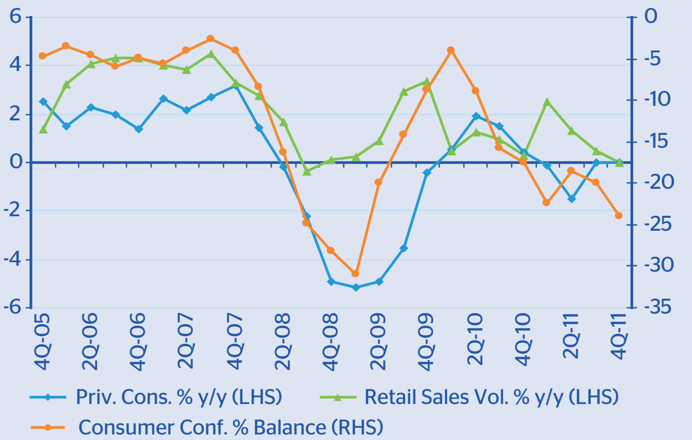
Private consumption fell by -1.2% in the first semester of the year, reflecting the weak position of households, with a deteriorating labor market and lower disposable income as they increase their savings. Recent household confidence indicators suggest that in forthcoming quarters the downward trend will persist, as the expectations about future economic conditions are worsening. Unemployment in the three months to August increased to 8.1%, from a previous 7.9% in July, being the highest level since 1996. This rise is partly explained by the cuts in public employment and possibly by the end of labor hoarding by some companies, as the halt in economic activity seems to be lengthier than initially expected. All in all, we foresee consumption to decline by -0.8% this year due to the base effect from the first semester (-1.2%) and a mild recovery to 1.1% in 2012.

Public consumption continues to show some resilience and has been increasing, although at a moderate pace, and it is expected to slowdown further.

Gross fixed capital formation fell by -1.1% in H1, as some investment was brought forward in 2010 in anticipation of the VAT increase. Recent surveys point to a sluggish investment in coming quarters as uncertainty linked to global developments and fiscal restraint persists. In addition, access to credit remains constrained. We expect investment to recover in 2012.

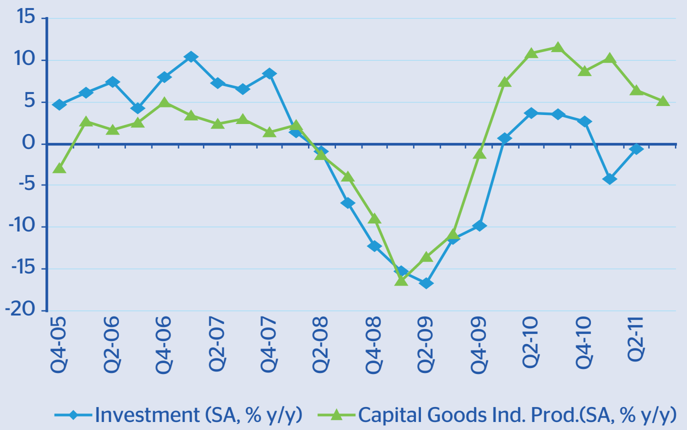
Net exports contributed negatively to growth in Q2, as exports fell by 1.3% q/q in spite of a favourable exchange rate. Imports have also posted important declines in the first semester, partly explained by the past purchase of big items in anticipation of the VAT increase such as aircrafts. Recent export order books are showing weakness. Overall, net exports will contribute very positively in 2011 but much less in 2012.

Chart 35
UK: Private consumption, retail sales and consumer confidence



Source: ONS and BBVA Research

Chart 36
UK: Gross fixed investment and production



Source: ONS and BBVA Research

Prices will remain high due to base effects

Prices continued to increase in September, again above expectations, while core CPI inflation also jumped, but inflation may peak soon and is expected to flex down next year once the impact of VAT increases fades away. We expect it to pick up to close to 5% by the end of 2011, averaging 4.5% over the year, and to fall significantly during 2012, but remaining clearly above 2%. With regard to core inflation, we have observed this year a pick-up due to the VAT increase but it is expected to average around 1% next year, as the slack in activity and in particular in the labour market reduces the chances of second round effects.

The budget balance remains on track but at risk, as economic activity slows down

Fiscal developments in the current fiscal year 2011-12 remain broadly in line with targets, but there are some increasing risks given the deterioration in economic activity. The government envisages reducing the deficit to -7.9% of GDP in 2011-12 from a previous outturn of -9.9%. By 2012-13 it aims to reduce the deficit by an additional 2 pp of GDP and gradually adjust it to reach a -1.5% by 2015-16. The budget execution up to September, which accounts for half of the fiscal year that runs from April to March, stands (excluding fiscal interventions) at -67.3 bn GBP year to date, and the target for the whole year is set at -122 bn GBP. Receipts have been strengthening across the board due to the increases in VAT and national insurance contributions. Spending, on the contrary, is showing more resilient to be adjusted as it stands 8bn above the level for the same time span last year. Debt stands at 80% of GDP.

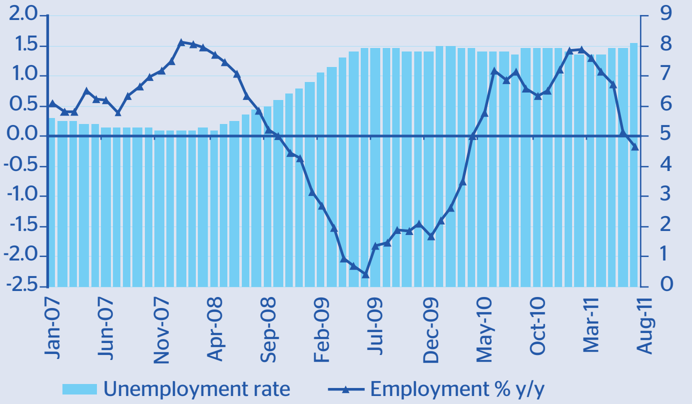
Further Quantitative Easing

In October the Bank of England decided to keep the official interest rates at 0.5% but to increase its Quantitative Easing (QE) programme by 75bn GBP (to be implemented over the next four months). This decision came as a surprise in terms of timing, as the announcement came earlier than expected, although given the deterioration of the economic outlook since the summer the debate within the BoE had shifted already from rate hikes to an eventual increase in QE. Indeed, after months of dissention, October minutes showed for the first time that all MPC members unanimously voted for a no rate change and for an increased in QE.

The impact on economic activity and inflation is uncertain. In a recent study, the Bank of England points out that the 200 bn GBP package already implemented led to a rise in of real GDP by 1.5-2 pp and increase of inflation between 0.75 and

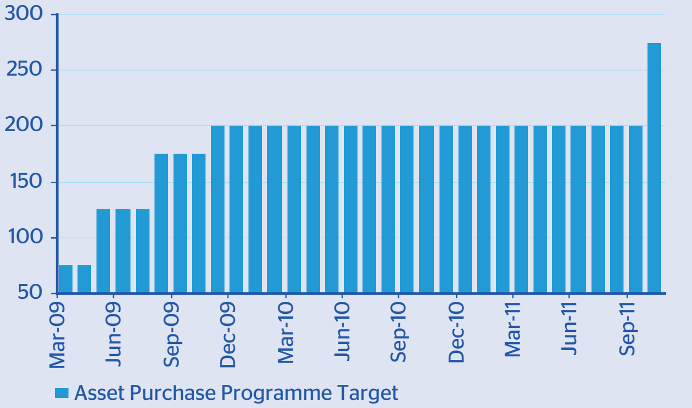
1.5 pp. This time, the programme may be less effective as the first round of QE in 2009 was accompanied by monetary expansion by both the Fed and the ECB, that provided a significant boost to global liquidity and risk appetite. On future moves, we keep our expectation for a first rate rise in early 2013 and we do not expect further QE unless the situation deteriorates markedly. However, if the outlook worsens the MPC may have to consider other type of assets or options. But, as the MPC expects its purchases to have a lag of four months, this decision will only be taken after its February 2012 meeting.

Chart 37
UK: Labour Market



Source: ONS and BBVA Research

Chart 38
UK: Asset Purchase Programme Target



Source: BoE and BBVA Research

4. Tables

Table 3

Euro Area forecasts

(YoY)	2008	2009	2010	2011	2012
GDP at constant prices	0.3	-4.2	1.7	1.7	1.0
Private consumption	0.3	-1.2	0.8	0.5	0.7
Public consumption	2.3	2.5	0.5	0.3	0.1
Gross Fixed Capital Formation	-1.2	-12.0	-1.0	2.4	1.7
Inventories (*)	-0.1	-0.7	0.6	0.1	0.0
Domestic Demand (*)	0.3	-3.5	1.0	1.0	0.8
Exports (goods and services)	0.7	-12.9	10.6	6.1	2.5
Imports (goods and services)	0.7	-11.7	8.9	4.7	2.1
External Demand (*)	0.0	-0.7	0.8	0.7	0.3
Prices and Costs					
CPI	3.3	0.3	1.6	2.6	1.6
CPI Core	2.4	1.3	1.0	1.7	1.7
Labour Market					
Employment	0.9	-1.8	-0.4	0.5	9.4
Unemployment rate (% of labour force)	7.7	9.6	10.2	9.9	9.7
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-2.1	-6.4	-6.2	-4.5	-3.4
External Sector					
Current Account Balance (% GDP)	-0.5	-0.5	-0.5	0.0	0.2

(*) Contribution to GDP growth
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Gross Domestic Product (by country)

(YoY growth rate)	2008	2009	2010	2011	2012
United States	-0.3	-3.5	3.0	1.6	2.3
EMU	0.3	-4.2	1.7	1.7	1.0
Germany	0.8	-5.1	3.6	2.9	1.2
France	-0.2	-2.6	1.4	1.6	1.0
Italy	-1.3	-5.2	1.2	0.7	0.3
Spain	0.9	-3.7	-0.1	0.8	1.0
UK	-0.1	-4.9	3.4	0.9	1.3
Latin America *	5.2	-0.6	6.6	4.5	3.8
Mexico	1.5	-6.1	5.4	3.8	3.3
EAGLES **	6.6	4.0	8.3	6.7	6.5
Turkey	0.7	-4.9	9.2	7.5	4.5
Asia Pacific	5.2	4.1	8.0	5.9	6.4
China	9.6	9.2	10.4	9.1	8.6
Asia (exc. China)	2.3	0.8	6.5	3.7	4.9
World	2.8	-0.6	5.1	3.9	4.1

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: October 31, 2011
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Inflation (Avg. by country)

(YoY growth rate)	2008	2009	2010	2011	2012
United States	3.8	-0.3	1.6	2.9	2.2
EMU	3.3	0.3	1.6	2.6	1.6
Germany	2.8	0.2	1.2	2.4	1.6
France	3.2	0.1	1.7	2.2	1.5
Italy	3.5	0.8	1.6	2.6	1.8
Spain	4.1	-0.3	1.8	3.1	1.2
UK	3.6	2.2	3.3	4.5	2.8
Latin America *	8.8	6.9	7.4	10.1	9.5
Mexico	5.1	5.3	4.2	3.5	3.5
EAGLES **	7.4	2.8	4.5	6.2	5.1
Turkey	10.4	6.3	8.6	6.5	6.0
Asia Pacific	5.7	0.3	2.7	4.8	3.7
China	6.0	-0.8	1.2	5.3	3.9
Asia (exc. China)	5.5	1.1	3.7	4.4	3.5
World	6.1	2.2	3.5	5.0	4.0

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: October 31, 2011
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Current Account (% GDP, by country)

	2008	2009	2010	2011	2012
United States	-4.7	-2.7	-3.3	-3.2	-3.0
EMU	-0.5	-0.5	-0.5	0.0	0.2
Germany	6.3	5.6	5.7	5.5	5.0
France	-1.7	-1.5	-1.7	-2.2	-2.5
Italy	-2.9	-2.0	-3.5	-3.9	-3.5
Spain	-9.6	-5.2	-4.5	-4.5	-3.0
UK	-1.6	-1.7	-2.5	-2.3	-2.0
Latin America *	-0.7	-0.3	-0.8	-0.7	-1.7
Mexico	-1.6	-0.7	-0.5	-0.8	-1.1
EAGLES **	3.9	2.8	1.9	1.7	1.4
Turkey	-5.6	-2.2	-6.4	-9.9	-8.3
Asia Pacific	4.8	3.8	3.2	2.7	2.9
China	9.1	5.2	5.2	4.4	4.5
Asia (exc. China)	1.4	2.3	1.9	1.6	1.8

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: October 31, 2011
Source: BBVA Research

Table 7

Macroeconomic Forecasts: Government Deficit (% GDP, by country)

	2008	2009	2010	2011	2012
United States	-3.2	-9.9	-8.9	-8.5	-7.1
EMU	-2.1	-6.4	-6.2	-4.5	-3.4
Germany	-0.1	-3.2	-4.3	-2.5	-1.5
France	-3.3	-7.5	-7.1	-5.8	-4.9
Italy	-2.7	-5.4	-4.6	-4.1	-1.9
Spain	-4.2	-11.1	-9.2	-6.5	-4.4
UK	-5.0	-11.5	-10.3	-8.3	-6.8
Latin America *	-1.1	-2.8	-2.0	-2.1	-2.4
Mexico	-1.6	-2.7	-3.4	-3.0	-3.0
EAGLES **	-1.8	-3.9	-3.0	-2.7	-2.6
Turkey	-1.8	-5.5	-3.7	-1.8	1.8
Asia Pacific	-2.8	-5.1	-3.8	-4.2	-3.5
China	-0.4	-2.2	-2.5	-2.0	-1.8
Asia (exc. China)	-4.4	-6.5	-4.7	-5.7	-4.7

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: October 31, 2011
Source: BBVA Research

Table 8

Financial Variables

Official Interest Rates (End period)	2008	2009	2010	2011	2012
United States	0.61	0.25	0.25	0.25	0.25
EMU	2.73	1.00	1.00	1.00	1.00
China	5.31	5.31	5.81	6.56	6.81
10-year Interest Rates (Avg.)					
United States	3.6	3.2	3.2	2.8	2.5
EMU	4.0	3.3	2.8	2.7	2.6
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.68	0.72	0.76	0.71	0.74
EMU	1.47	1.39	1.33	1.40	1.35
UK	1.82	1.56	1.54	1.60	1.57
China (RMB per USD)	6.88	6.83	6.74	6.42	6.16

Forecast closing date: October 31, 2011
Source: BBVA Research

Table 9
Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	0.5	0.0	0.6	1.0	0.8
Public consumption	3.1	3.3	1.7	0.9	0.6
Gross Fixed Capital Formation	1.0	-11.4	5.2	8.9	2.9
Inventories (*)	0.0	-0.8	0.6	0.0	0.0
Domestic Demand (*)	**1.0**	**-2.3**	**2.1**	**2.2**	**1.1**
Export	2.1	-13.6	13.4	7.7	4.8
Import	3.0	-9.2	11.5	7.2	5.1
Net export (*)	**-0.2**	**-2.8**	**1.4**	**0.6**	**0.2**
GDP	**0.8**	**-5.1**	**3.5**	**2.9**	**1.2**
Inflation	**2.8**	**0.2**	**1.2**	**2.4**	**1.6**

(*) Contribution to growth
Source: BBVA Research

Table 10
France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	0.2	0.2	1.6	0.7	0.8
Public consumption	1.2	2.3	1.4	0.5	0.2
Gross Fixed Capital Formation	0.1	-8.8	-1.6	4.3	2.9
Inventories (*)	5.0	-1.4	0.1	0.2	0.0
Domestic Demand (*)	**0.1**	**-2.4**	**1.0**	**1.5**	**1.0**
Export	-0.6	-12.2	9.9	4.6	4.1
Import	0.6	-10.6	8.3	4.2	3.8
Net export (*)	**-0.4**	**-0.2**	**0.4**	**0.0**	**0.0**
GDP	**-0.2**	**-2.6**	**1.4**	**1.6**	**1.0**
Inflation	**3.2**	**0.1**	**1.7**	**2.2**	**1.5**

(*) Contribution to growth
Source: BBVA Research

Table 11
Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	-0.8	-1.8	1.0	0.7	0.3
Public consumption	0.5	1.0	-0.6	-0.2	-1.2
Gross Fixed Capital Formation	-3.8	-12.0	2.3	1.2	0.8
Inventories (*)	-0.2	-0.6	0.8	0.0	0.0
Domestic Demand (*)	**-1.4**	**-4.0**	**1.8**	**0.6**	**0.0**
Export	-4.4	-18.4	8.9	4.5	4.0
Import	-4.4	-13.8	10.3	3.7	2.7
Net export (*)	**0.0**	**-1.2**	**-0.5**	**0.1**	**0.3**
GDP	**-1.3**	**-5.2**	**1.2**	**0.7**	**0.3**
Inflation	**3.5**	**0.8**	**1.6**	**2.6**	**1.8**

(*) Contribution to growth
Source: BBVA Research

Table 12
Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	1.3	-1.1	2.3	-4.2	-3.4
Public consumption	0.4	3.7	1.2	-4.6	-2.8
Gross Fixed Capital Formation	-0.3	-11.3	-4.9	-9.7	-6.9
Inventories (*)	0.0	-0.6	-0.1	-0.4	0.0
Domestic Demand (*)	**0.9**	**-3.2**	**0.7**	**-6.1**	**-4.1**
Export	-0.1	-11.6	8.8	7.2	5.8
Import	2.3	-10.6	5.1	-6.1	-1.5
Net export (*)	**-1.0**	**0.7**	**0.6**	**4.7**	**2.6**
GDP	**-0.1**	**-2.5**	**1.3**	**-1.4**	**-1.5**
Inflation	**2.7**	**-0.9**	**1.4**	**3.4**	**1.8**

(*) Contribution to growth
Source: BBVA Research

Table 13
Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	-0.6	-4.3	1.3	0.4	0.5
Public consumption	5.8	3.2	-0.7	-0.3	-2.7
Gross Fixed Capital Formation	-4.8	-16.0	-7.5	-5.1	-0.6
Equipment and other products	-3.0	-21.2	-2.1	-0.5	2.8
Construction	-5.9	-11.9	-11.1	-8.7	-3.2
Housing	-10.7	-24.5	-16.5	-7.4	0.9
Other construction	-0.8	-0.1	-7.2	-9.4	-5.7
Inventories (*)	0.1	0.0	0.1	0.0	0.0
Domestic Demand (*)	-0.6	-6.4	-1.1	-1.0	-0.4
Export	**-1.1**	**-11.6**	**10.3**	**10.1**	**5.1**
Import	-5.3	-17.8	5.5	3.0	-0.3
Net export (*)	1.5	2.7	1.0	1.8	1.4
GDP	**0.9**	**-3.7**	**-0.1**	**0.8**	**1.0**
Inflation	**4.1**	**-0.3**	**1.8**	**3.1**	**1.2**

(*) Contribution to growth
Source: BBVA Research

Table 14
UK: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	-1.5	-3.5	1.1	-0.8	1.1
Public consumption	1.6	0.0	1.5	1.4	-1.3
Gross Fixed Capital Formation	-4.8	-13.4	2.6	-1.2	3.3
Inventories (*)	-0.4	-1.0	1.3	-0.3	0.0
Domestic Demand (*)	**-1.9**	**-5.5**	**2.6**	**-0.6**	**1.1**
Export	1.3	-9.5	6.2	6.4	4.6
Import	-1.2	-12.2	8.5	1.1	3.7
Net export (*)	**0.8**	**1.1**	**-0.8**	**1.5**	**0.2**
GDP	**-1.1**	**-4.4**	**1.8**	**0.9**	**1.3**
Inflation	**3.6**	**2.2**	**3.3**	**4.4**	**2.8**

(*) Contribution to growth
Source: BBVA Research

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