

Europe Outlook

November 2014



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Some imbalances have been corrected, but the growth potential is reduced

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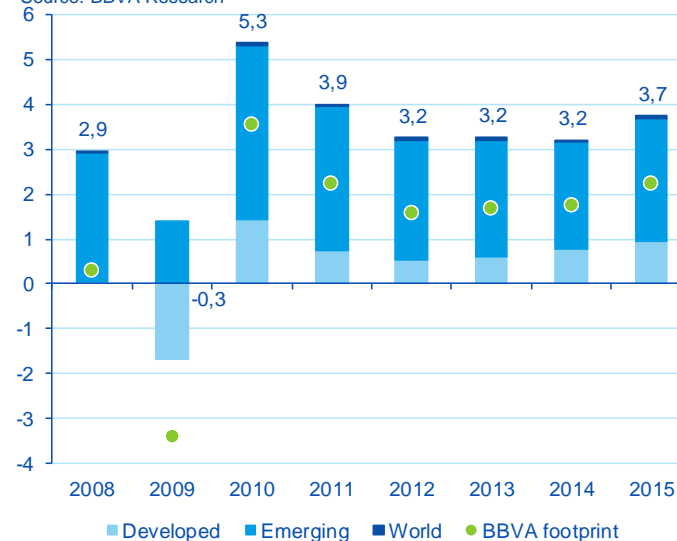
Country breakdown

Main messages

- 1 **The global expansion goes on slower than expected** except in the US (and Mexico)
- 2 **The likelihood of the risk scenario increases** due to geopolitical risks and the lower traction of support policies
- 3 **Volatility, extremely low until now, has increased a bit**, quickly over a very short period. Warrants monitoring

Global GDP growth (%)

Source: BBVA Research



How do we assess the growth stance in BBVA's footprint?

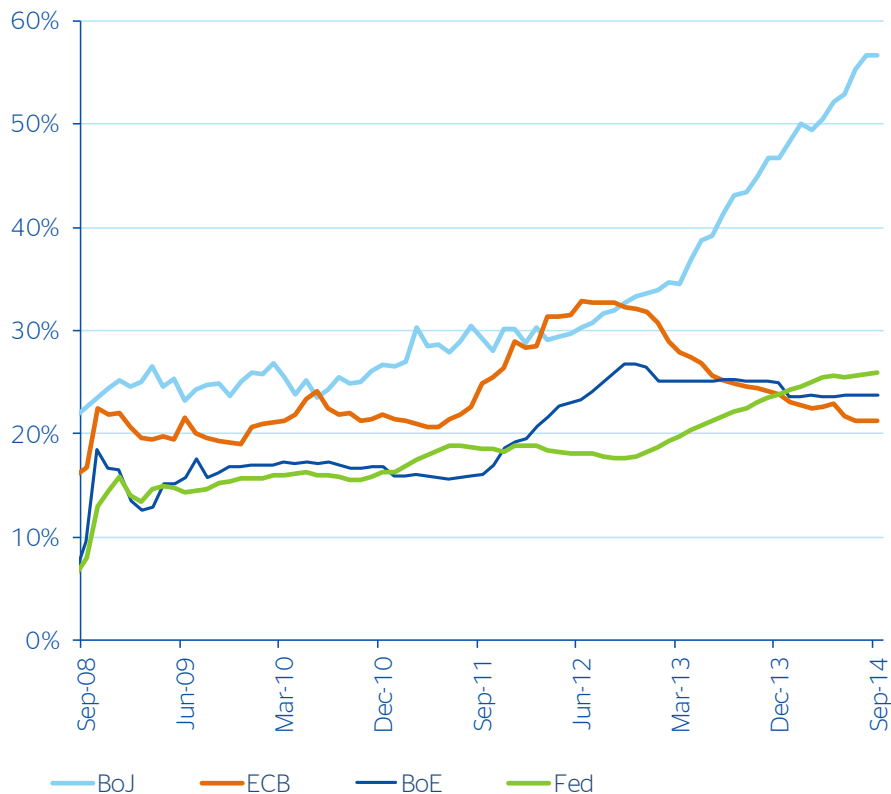
	US	EMU	Spain	Mex	Latam-5			Turkey	China	Em. Asia
					Arg	Ven	Andean C.			
2014	↑	↓↓	≈	≈	↓↓	↓↓	↓↓	≈	≈	≈
2015	≈	↓↓	↓↓	≈	↓↓	↓↓	↓↓	↓↓	≈	≈

No change: ≈
 Bias without change in the forecast: ↑
 Forecast revision relative to July's MC: ↑↑

The economic conditions are in place for growth: suitable funding conditions and less stringent fiscal policy

Central Banks, Balance Sheet, % GDP

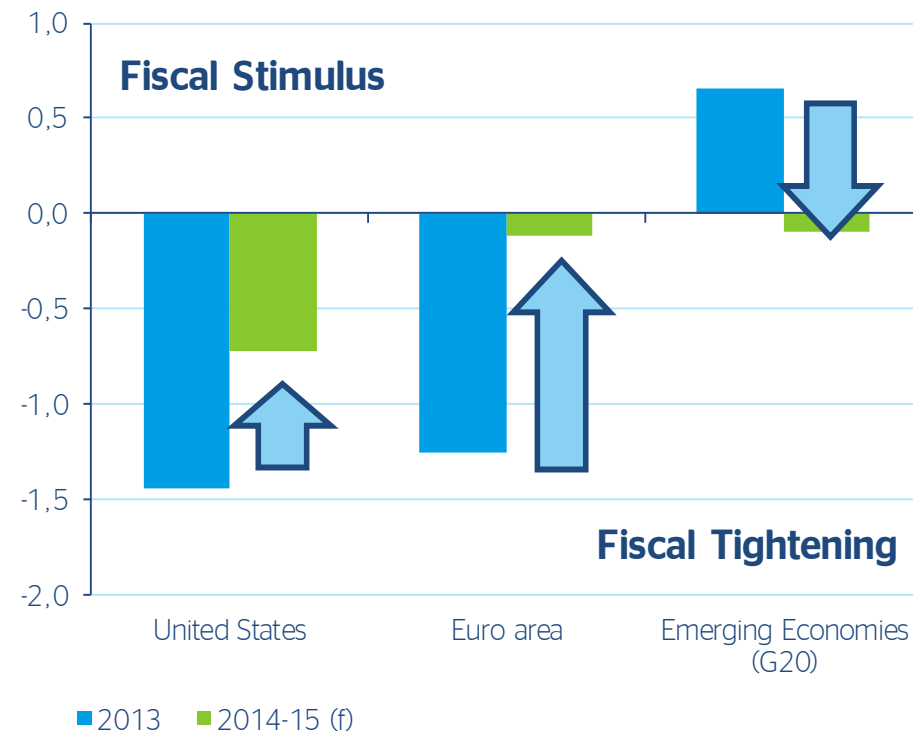
Source: BBVA Research with Haver data



Fiscal Stimulus

General Government. Annual change (multiplied by -1) of the Cyclically Adjusted Primary Balance, pp of Potential GDP

Source: BBVA Research with IMF Fiscal Monitor data. Oct-14

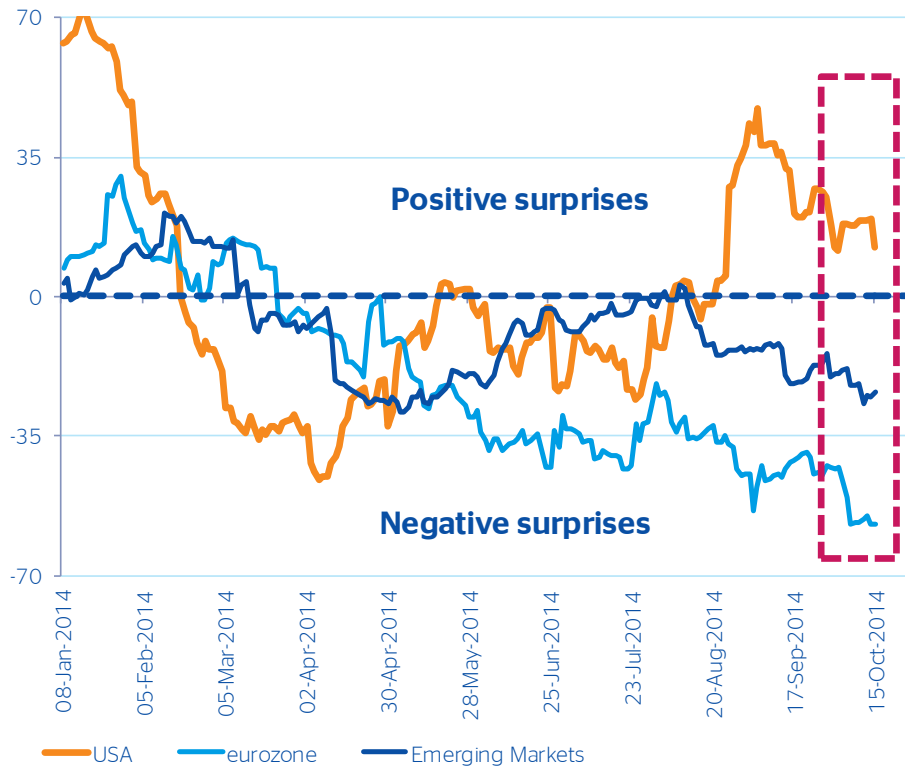


As of late volatility has increased from extremely low levels due to disappointing economic expectations ...

Economic Surprises vs Consensus

Citigroup Index (*)

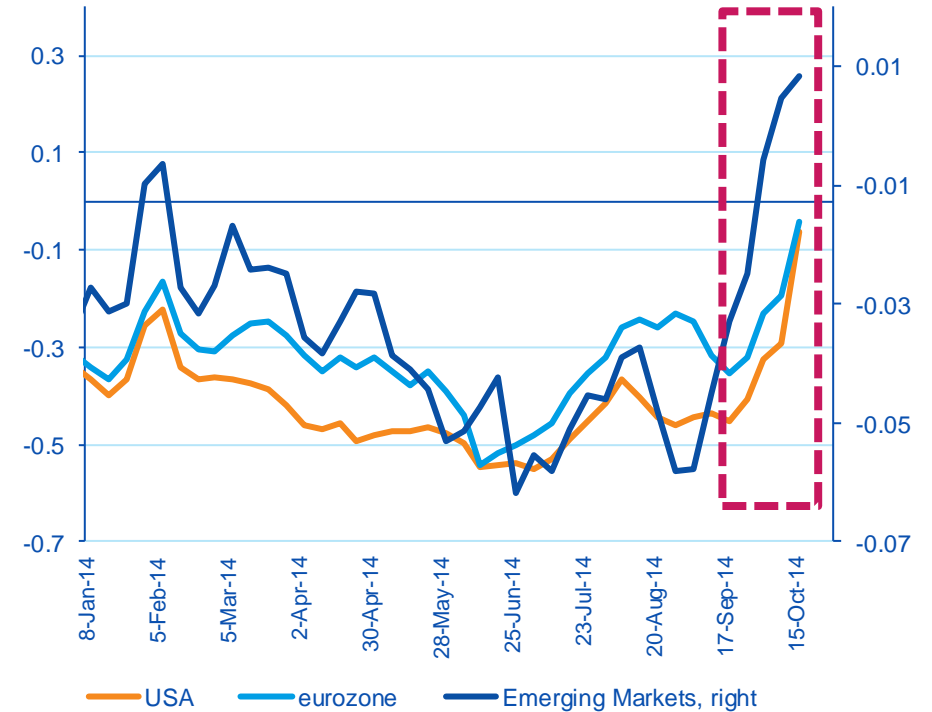
Source: Haver and Citigroup



(*) A positive (negative) reading of the Economic Surprise Index suggests that economic releases have on balance beating (below) Bloomberg consensus.

BBVA Financial Stress Index

Source: BBVA Research

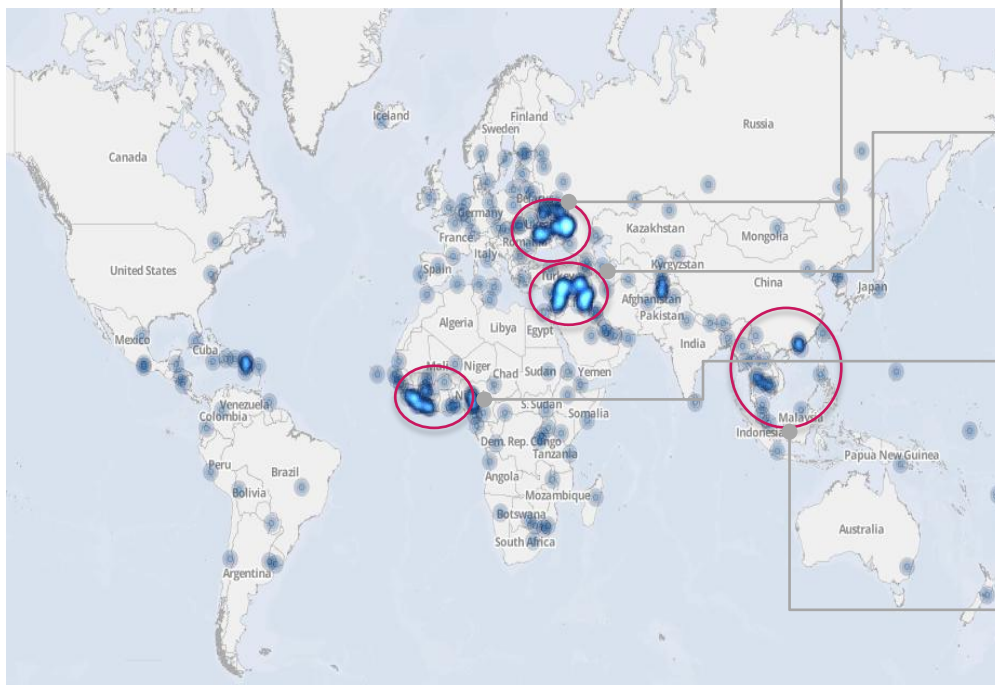


... and an accumulation of potential disruptions due to geopolitical tensions could impact on the economic scenario

BBVA World Conflict Heat-map (3Q-2014)

(Number of conflict / Total events)

Source: www.gdelt.org & BBVA Research



Ukraine-Russia

Ceasefire in place but still fragile.

Sanctions 2.0 in place

Waiting for the Winter

IS advances in M. East

Stop the IS advance: The Coalition strikes

Turkey's low profile but key role

Ebola Outbreak

A rapid spread but regional

The real "Black Swan"

Social Unrest in Asia

Thailand's "déjà vu"

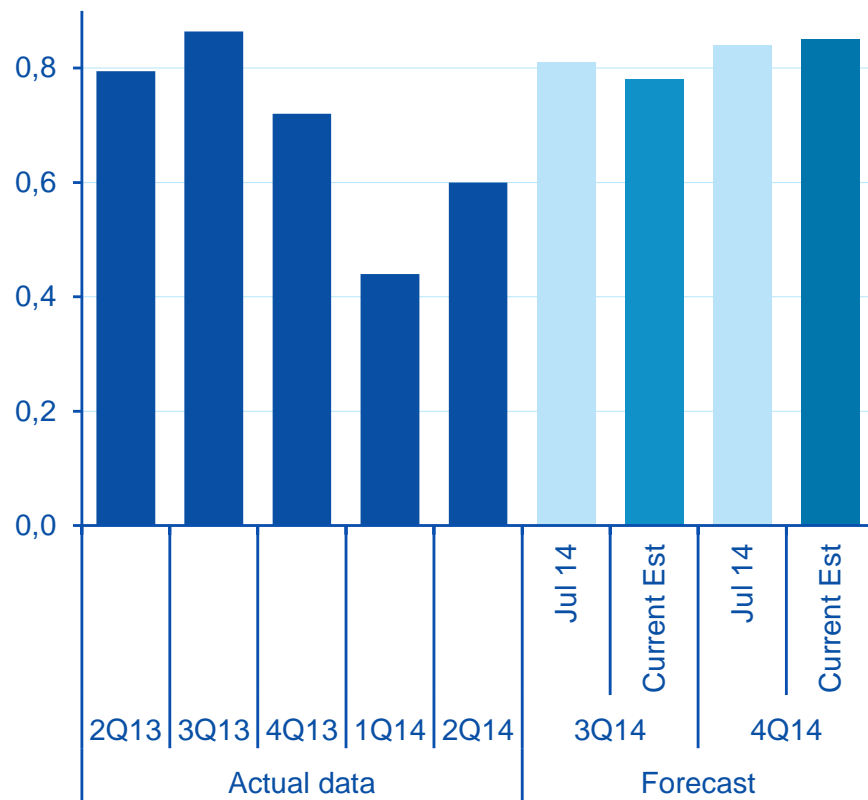
Democratic demands in Hong Kong

All in all, current indicators still point to an improvement in global economic growth in the second half of 2014

Global GDP growth based on BBVA-GAIN

(QoQ %)

Source: BBVA Research



Indicators continue to point out towards a modest recovery in global growth, although probably heterogeneous) ...

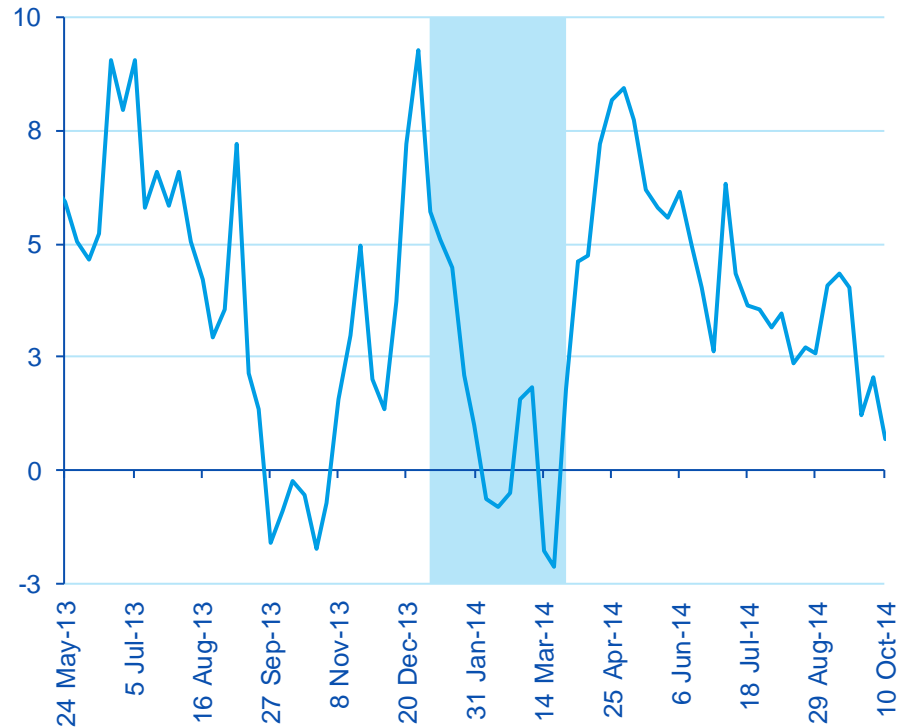
... given: supportive funding conditions and confidence, both coherent with an easing mood from fiscal and monetary policies.

However, if volatility continues, there is a risk that further readings worsen

US: Strong rebound in 2Q14 to be followed by growth over 2.5% in 2H14

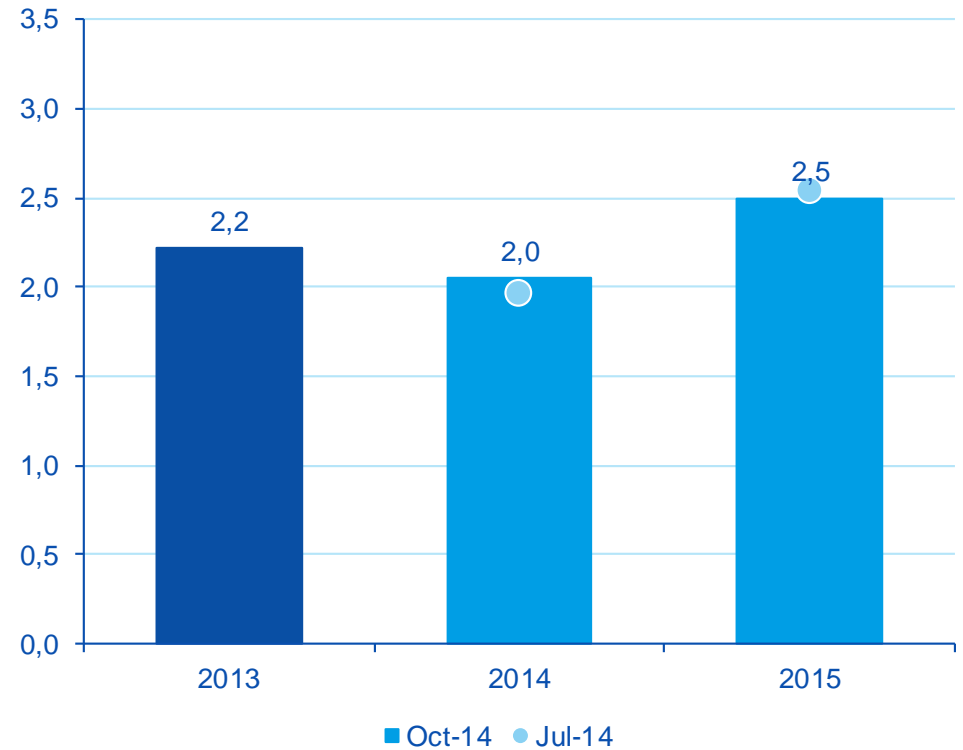
US: BBVA Weekly Activity index

% change
Source: BBVA Research



US: GDP growth (YoY)

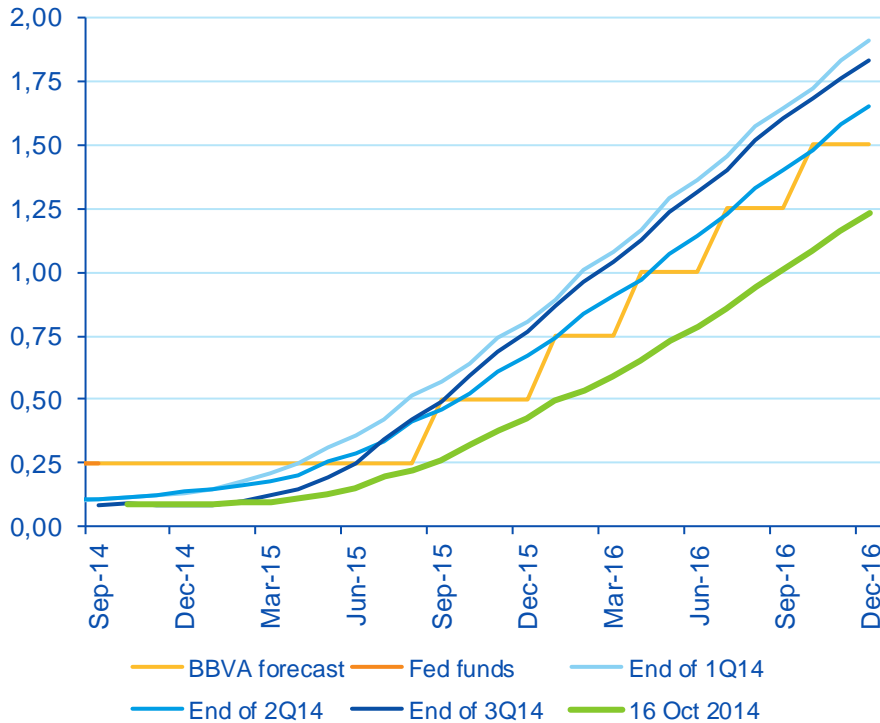
Source: BBVA Research, BEA



US: the Fed sticks to its “no-plan” plan: monetary policy are “as slow as data allows”

US: Fed Funds (%)

Source: BBVA Research



Timing of the rate hike and the path of policy rate remains **data dependent**

A **dovish bias** seems arising from the delayed changes to forward guidance “to err on the side of **patience**” and current lower inflationary pressures

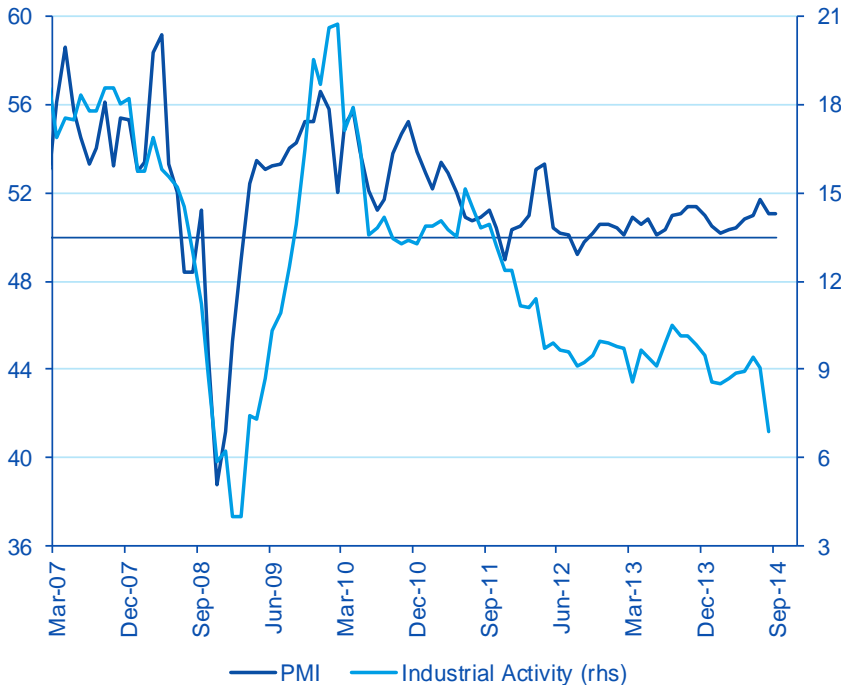


China: some negative surprises on activity and credit growth during the summer

Industry production fell sharply in August, due to sluggish domestic demand

China: manufacturing confidence and activity

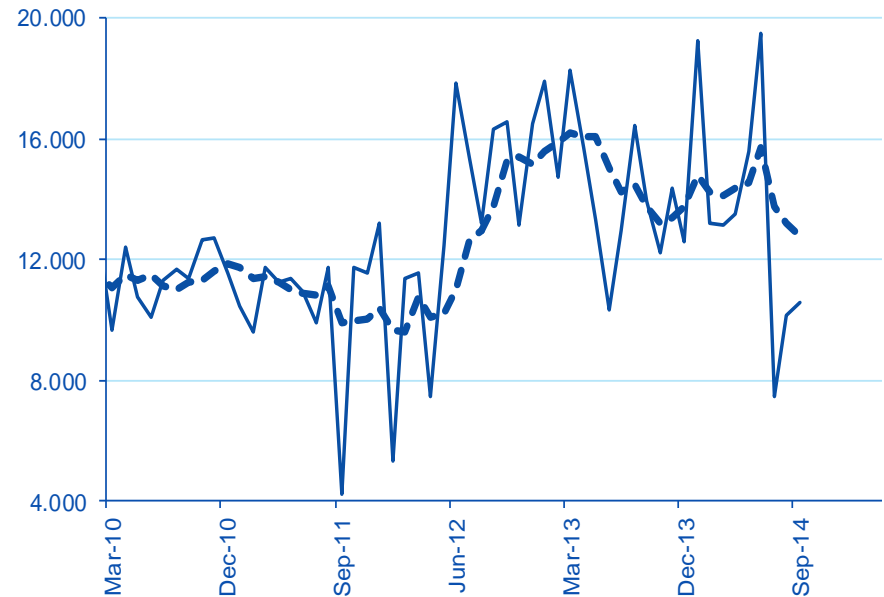
Source: BBVA Research, PMI



The July-August adjustment in the new funding was driven by real estate slowdown and shadow banking tighter control

China: total social financing monthly level %, CNY100mn

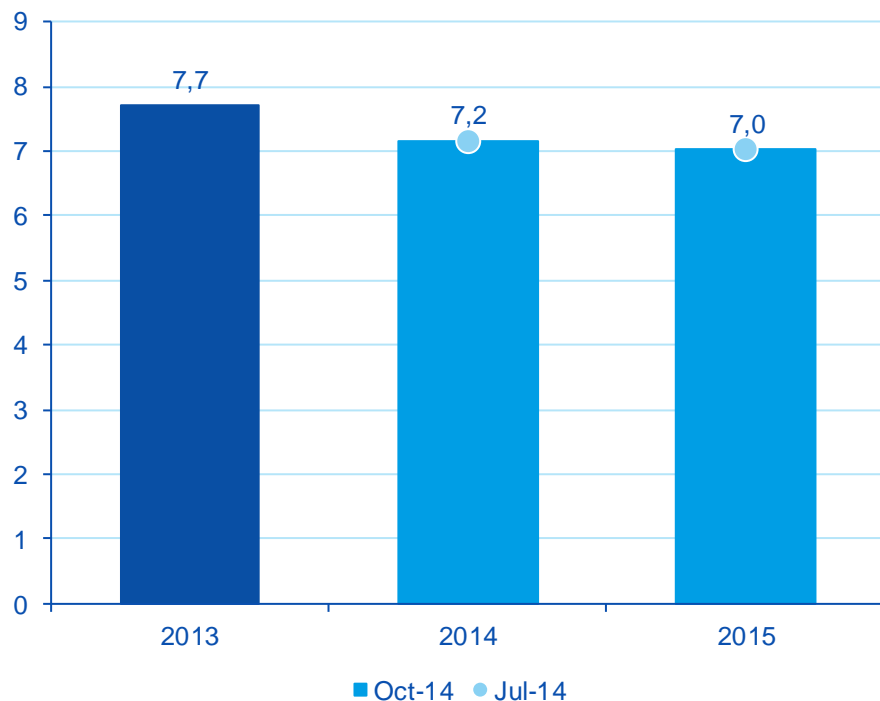
Source BBVA Research



China: The baseline scenario unchanged expecting policy support

China: GDP Growth (% , y-o-y)

Source: BBVA Research



Economic rebalancing from investment to consumption will continue, but slowly

Negative bias from foreign demand: Japan's tax tightening and eurozone downward revision

Policies will need to support economic activity:

- Expected easing in monetary policy (RRR cuts or liquidity injection)
- More balanced fiscal policy (expansionary at the central gov. level; consolidation at the local level)
- Push forward structural reforms.

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Country breakdown

What's new in Europe

1) Incoming data: some downside risks materialized, both external (geopolitical) and idiosyncratic

2) External environment: Ukraine crisis weighs on confidence and, therefore, on investment (Germany), and on exports, to a lesser extent

3) Credit: more evidence of a demand issue in the current situation, more than a supply one

4) France and Italy: deterioration in confidence; some progress in the reform agenda, but slower than expected

5) Exchange rate: Euro depreciation after the ECB's new measures and is projected to continue over the medium term and support growth

6) Monetary policy: higher likelihood of QE

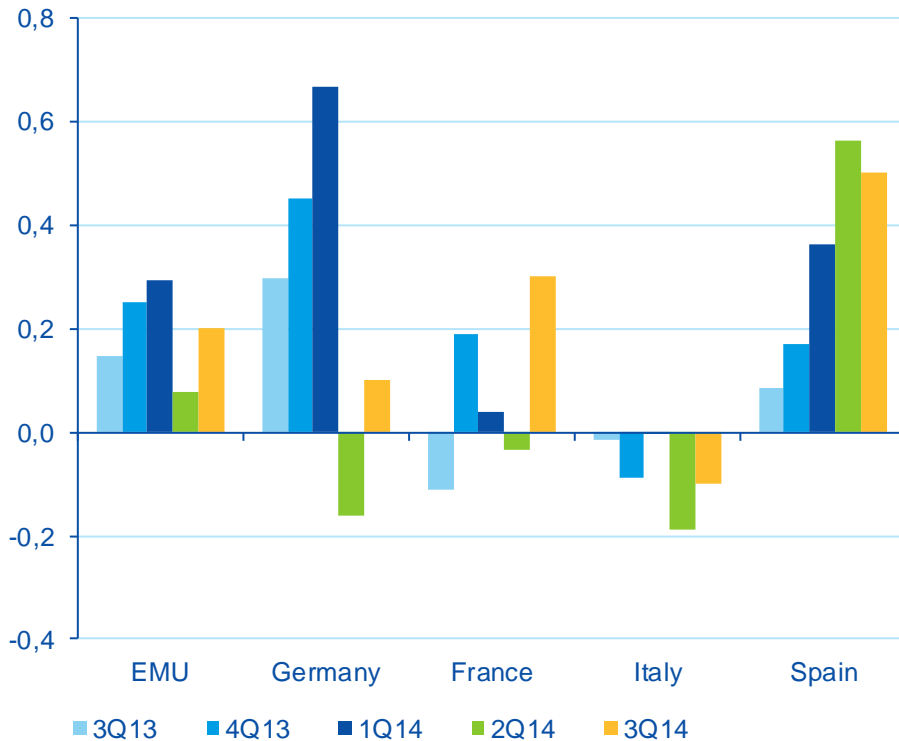
7) Fiscal policy: open debate about French, Italian and German deficits and investment in infrastructures. Less restrictive stance.

1) Incoming data: weak growth in 3Q (0.2% QoQ)

Better-than-expected performance of the French economy

GDP growth (% QoQ)

Source: BBVA Research



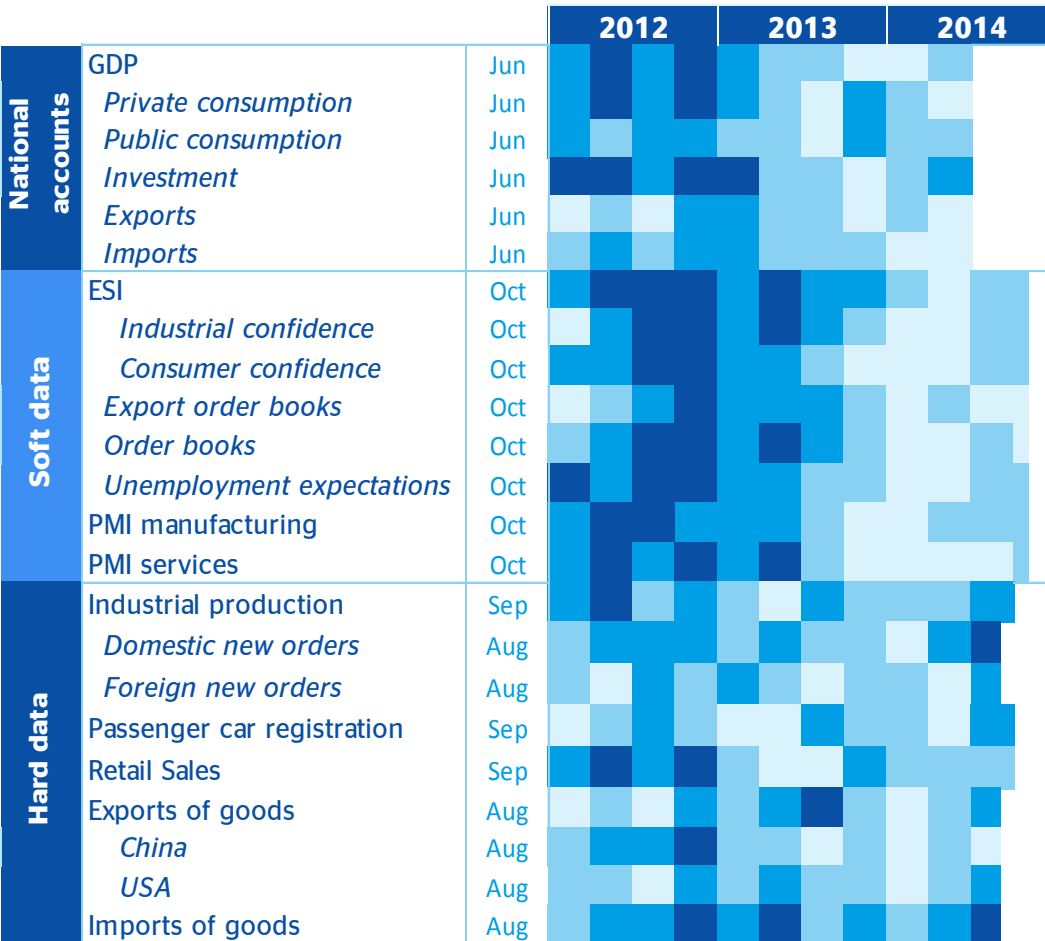
Growth driven by positive private consumption behavior; investment still weak

Eurozone: quarterly GDP growth (%) by components

	4Q13	1Q14	2Q14	3Q14	
				Observed	BBVA Research
GDP	0,3	0,3	0,1	0,2	0,1
Private consumption	-0,1	0,2	0,3		
Public consumption	-0,2	0,7	0,2		
Investment	0,3	0,6	-0,9		
Inventories (1)	-0,2	0,2	-0,2		
Domestic demand (1)	0,0	0,4	0,0		
Exports	1,1	0,3	1,3		
Imports	0,4	0,6	1,3		
Net exports (1)	0,3	-0,1	0,1		

(1) Contributions to QoQ GDP growth.
Sources: Eurostat and BBVA Research

1) Incoming data: recovery set back in 2H14



Significant fall in confidence over the summer across countries and sectors, linked to geopolitical tensions

Disappointing hard data

In October the deterioration of confidence has stopped

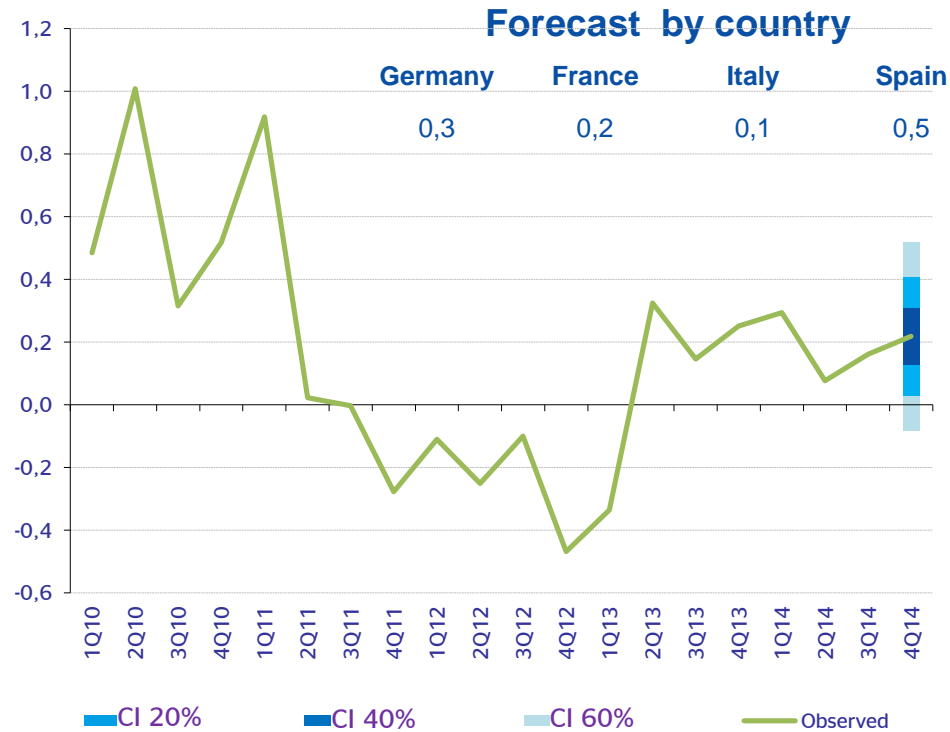
Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken. For confidence data, standardized values are used, and the growth and fall are related to the mean.



1) Incoming data: very weak recovery in 2H14

MICA-BBVA GDP short term model (% QoQ)

Sources: Haver and BBVA Research



Growth expected stable at 0.2% in 4Q; but data are very limited

By country, feeble growth across the region...

... except for Spain and Ireland

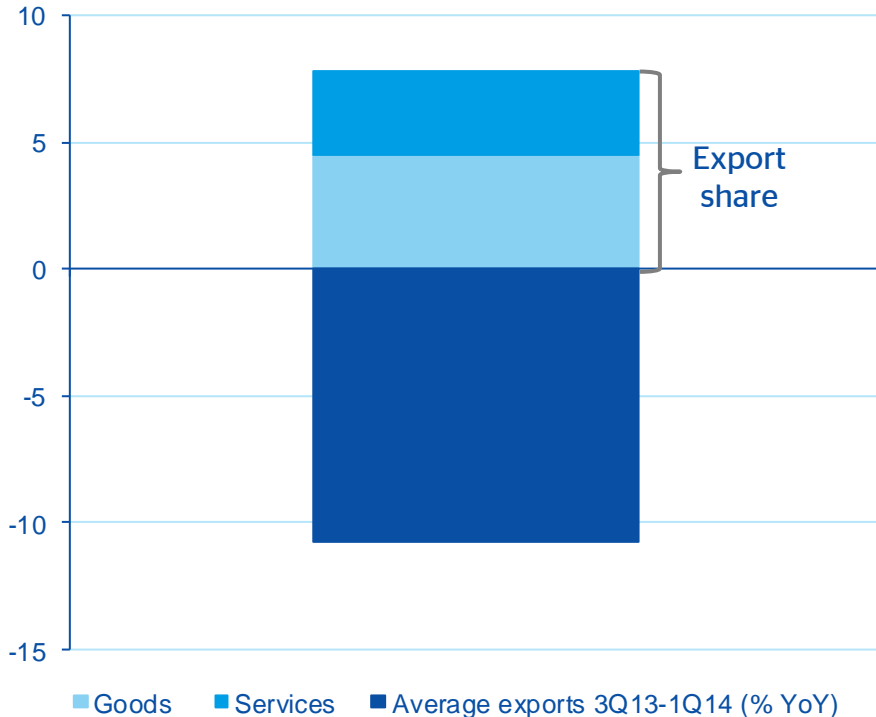
2) Geopolitical tensions persist: trade channel (lower growth in Russia), but also impact on confidence

The eurozone exports to Russia are relatively small (4,5% goods, 3,3% services)

Russian GDP forecasts have been slashed about 2,5pp since the beginning of the conflict

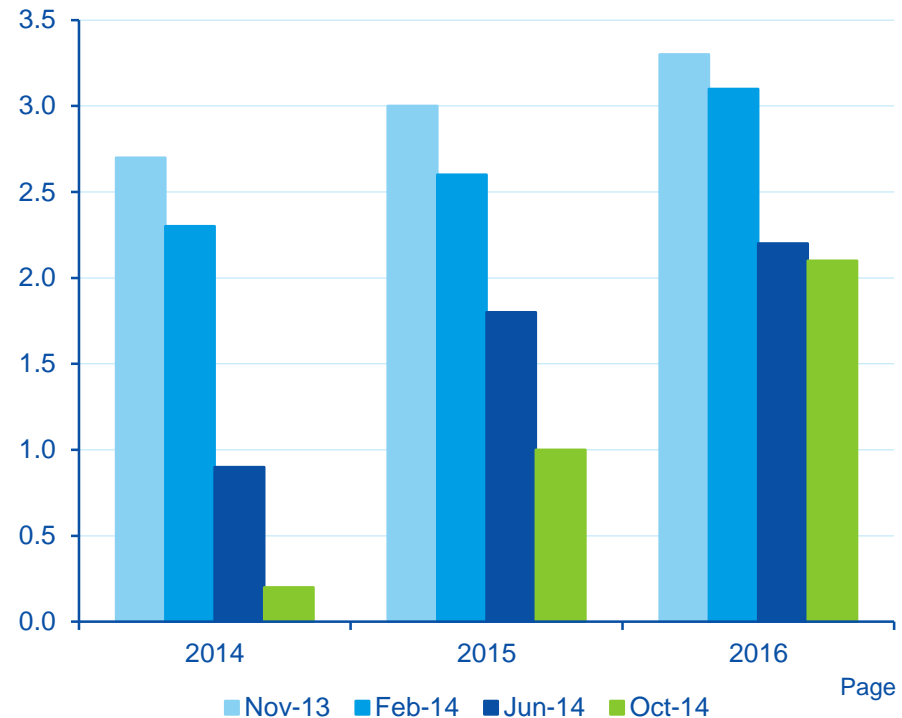
Eurozone: exports to Russia

Source: ECB and BBVA Research



Russia: annual GDP growth forecasts (%)

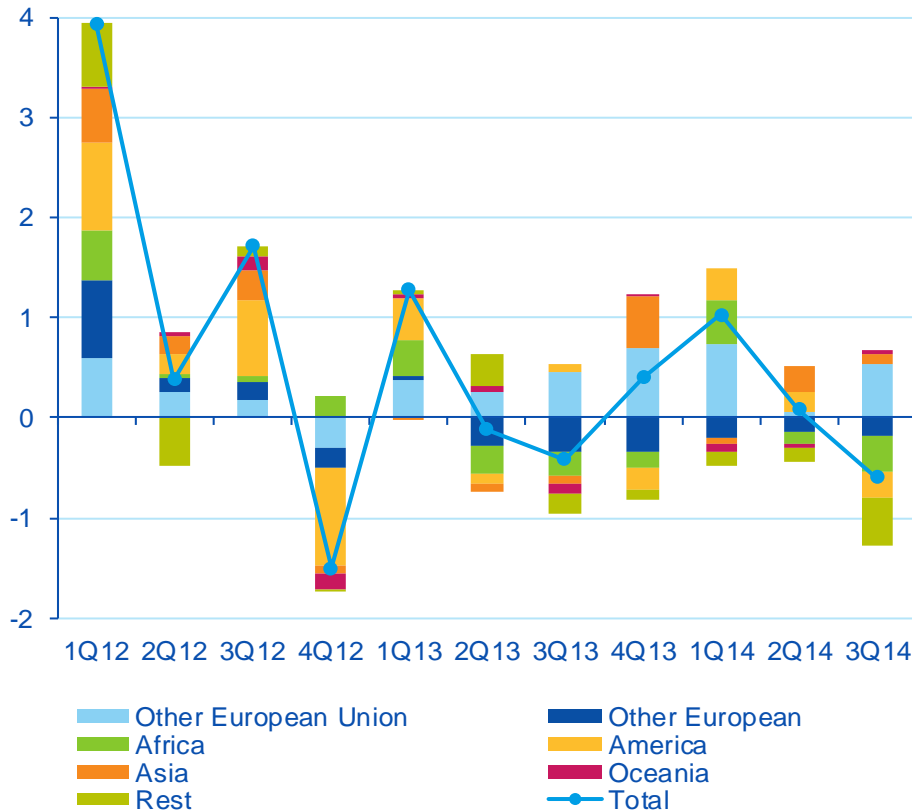
Source: FocusEconomics



2) And weak demand from developed countries

UEM: Exports by destination (%3m/3m)

Source: BBVA Research



Volatile but weaker exports lately

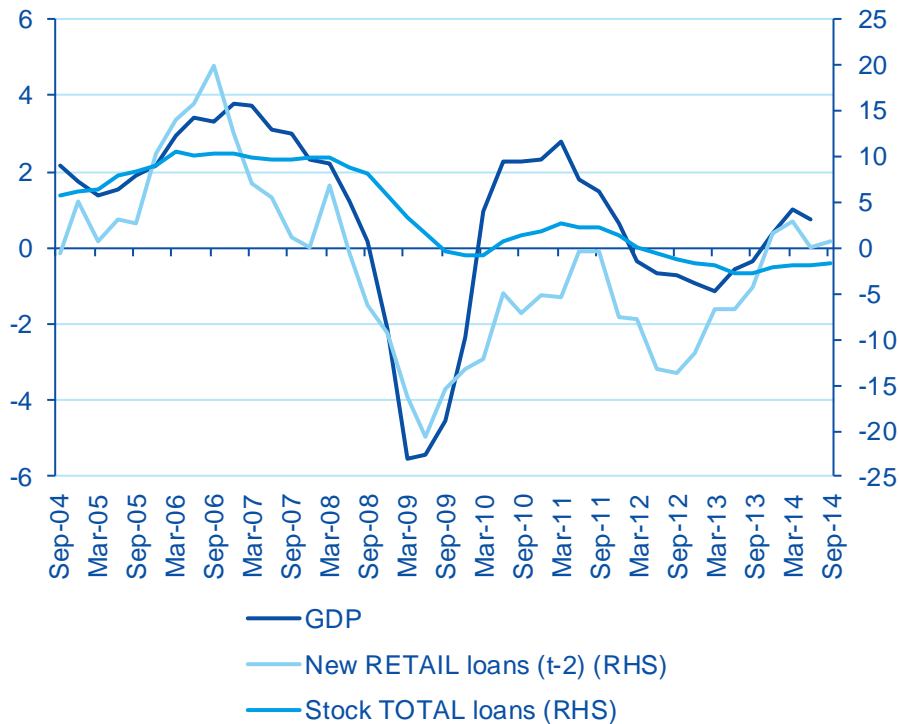
Exports to the UK and the rest of the EU have maintained the tone

Weak demand from emerging markets

3) The new credit to households and small businesses has not taken off...

Eurozone (% YoY)

Note: Retail loans is the sum of loans to households and companies up to 1M€
Sources: BCE, Eurostat and BBVA Research



The new credit and real variables (consumption and investment) are flows and are strongly correlated (correlation of 0.9, compared to 0.6 with the stock of credit)

The new consumer credit and for small and medium enterprises has been growing for half a year, but with some doubts

The new credit to large companies is still falling, partly because of their increased use of the market

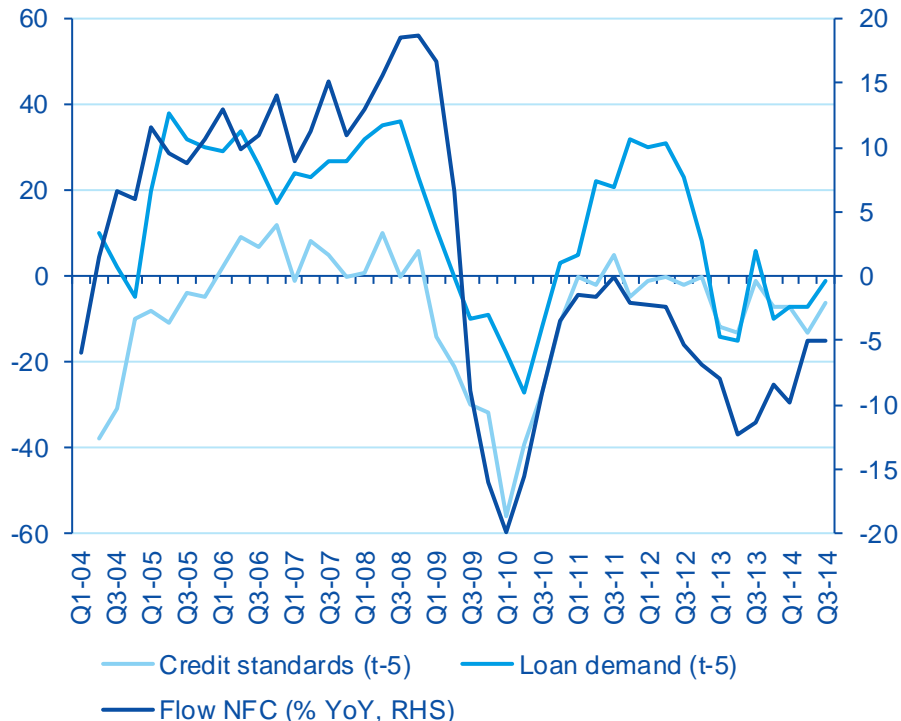
3) ... despite lower credit constraints

Higher correlation between credit flows and loan demand than with credit supply.

In 2008 and 2012, supply factors could explain a larger fall in credit to private sector. Currently, limited evidence on supply constraints

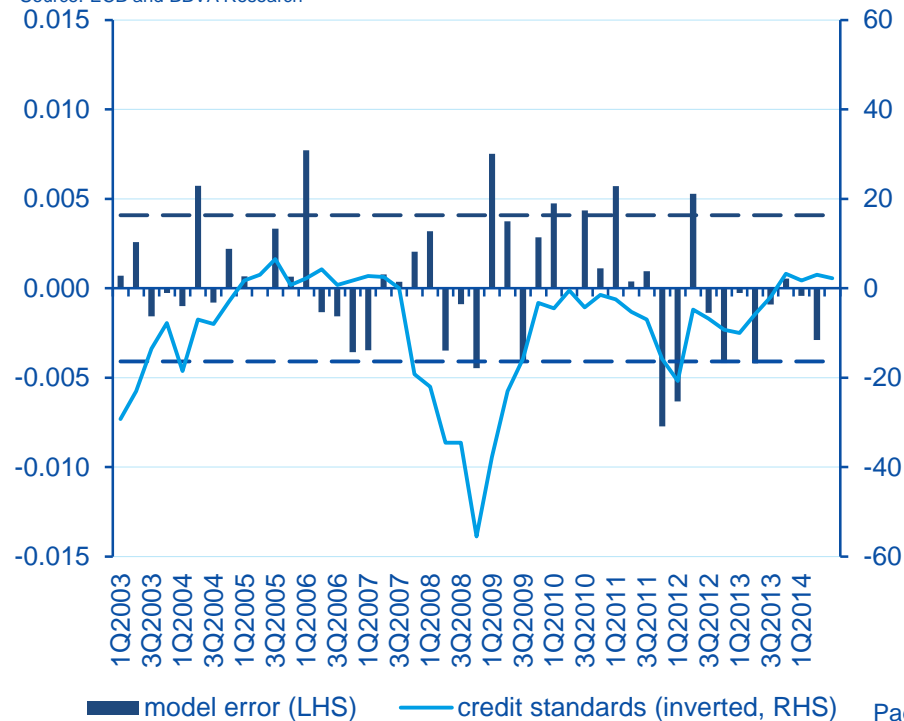
Eurozone: Flow, credit standards and loan demand

Source: ECB and BBVA Research



Eurozone: Demand model estimation error and credit standards

Source: ECB and BBVA Research



4) Italy / France: Lower growth momentum linked to internal issues

Italy

- GDP contracted in 2Q14 (-0,2% QoQ) and weak data for 3Q14
- The electoral and institutional reforms broadly on track (to be completed by February)
- Labour market reform launched (flexible dismissal), but details to be adopted throughout 2015
- Spending review delayed
- Growing internal impatience for the slowness of reforms

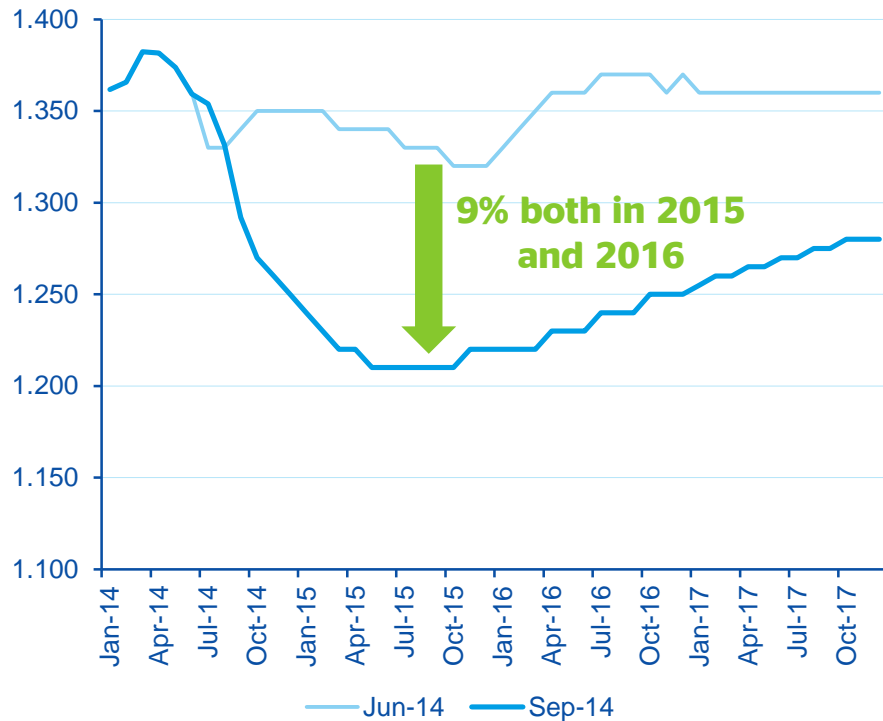
France

- Reduction of corporate and labour taxes to regain competitiveness
- € 50bn spending cut expected in 3 years (2.5% of GDP), but still to be detailed
- Launch of reforms in retail opening hours and professional services (December 2015)
- Deteriorated political landscape despite the government reshuffling.

5) Stronger depreciation should help sustain the recovery in 2015...

Dollar/Euro exchange rate

Source BBVA Research



The euro depreciation is due to:
 (a) Increasing cyclical divergence with US
 (b) Increasing differences in monetary policy

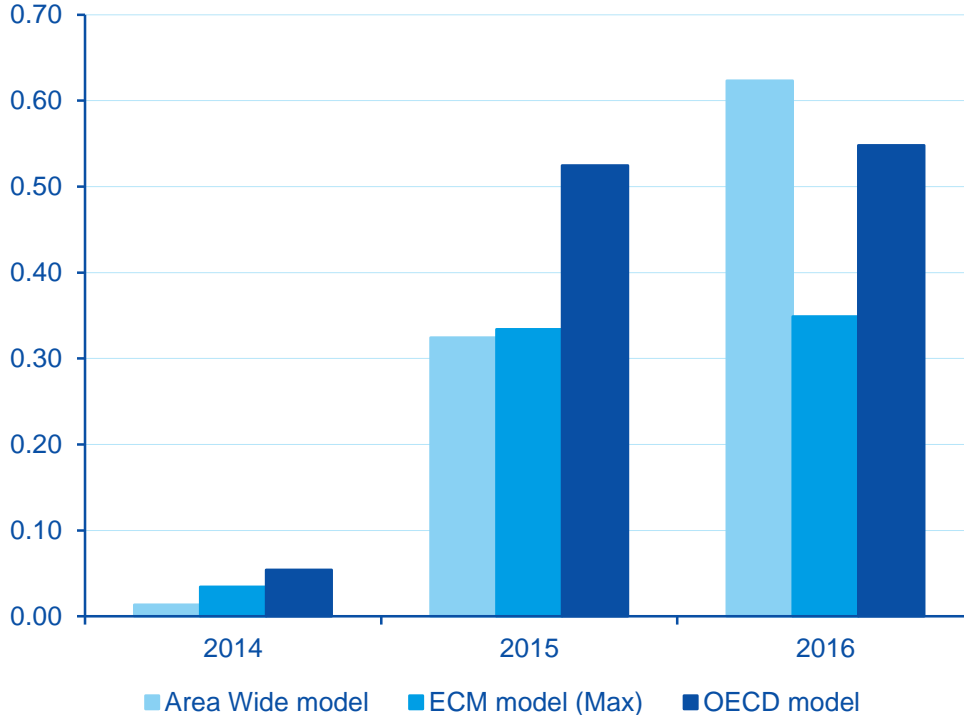
5) ...with differentiated effects across countries

Projected impact: 0.3pp in 2015

Larger impact on Italy and Germany than in Spain or France

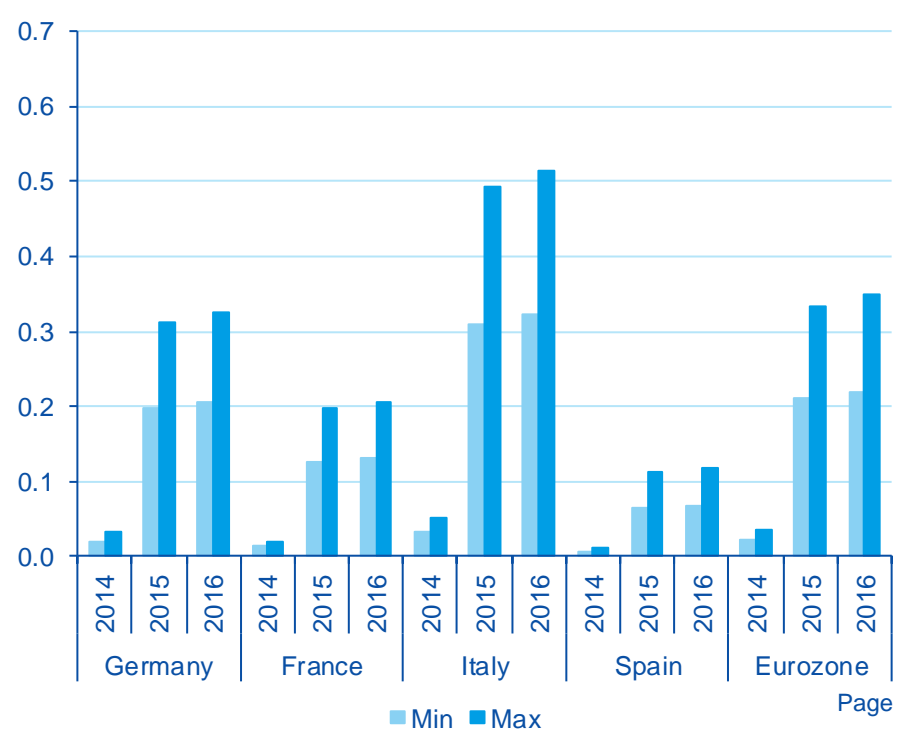
Eurozone: effect of euro depreciation on annual GDP growth (pp)

Source OECD and BBVA Research

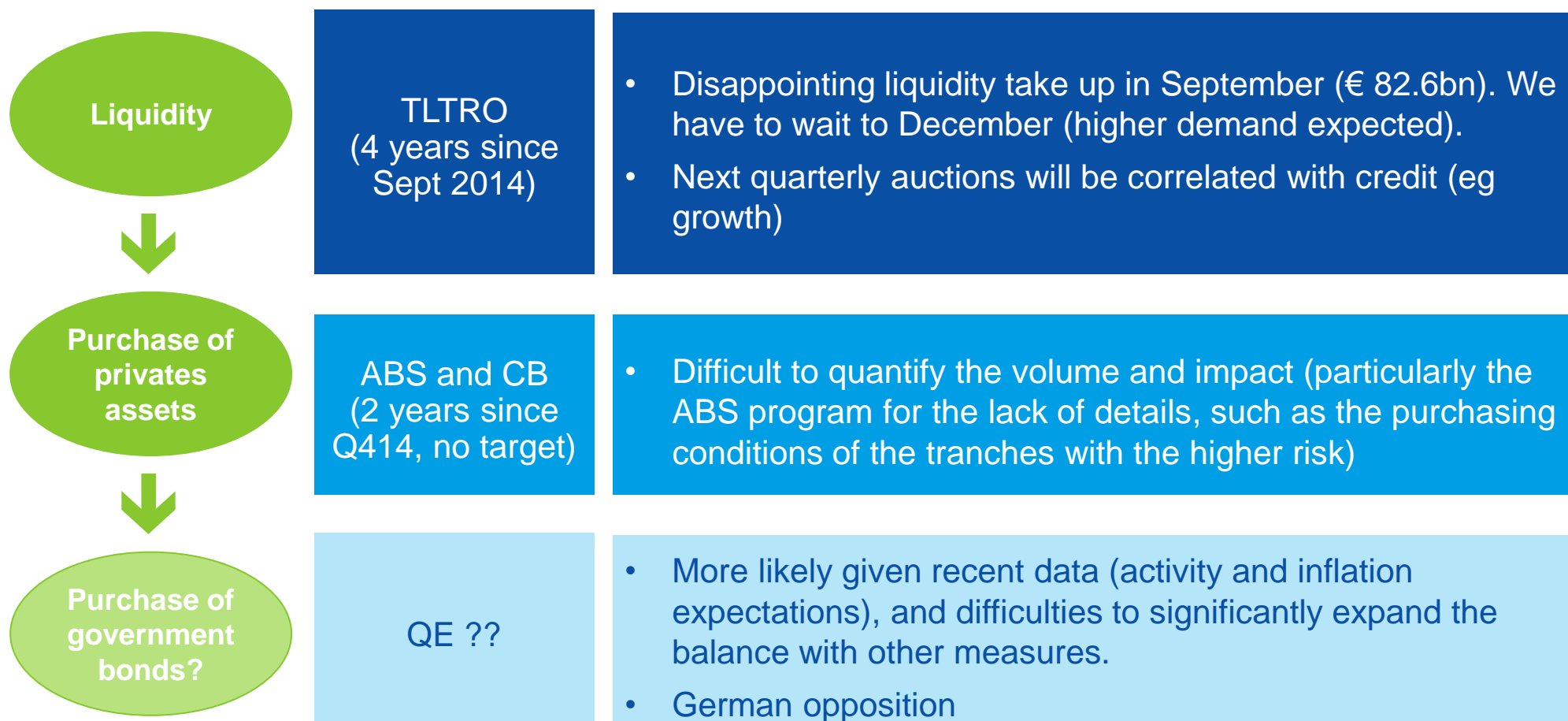


Effect of euro depreciation on annual GDP growth (pp). ECM model

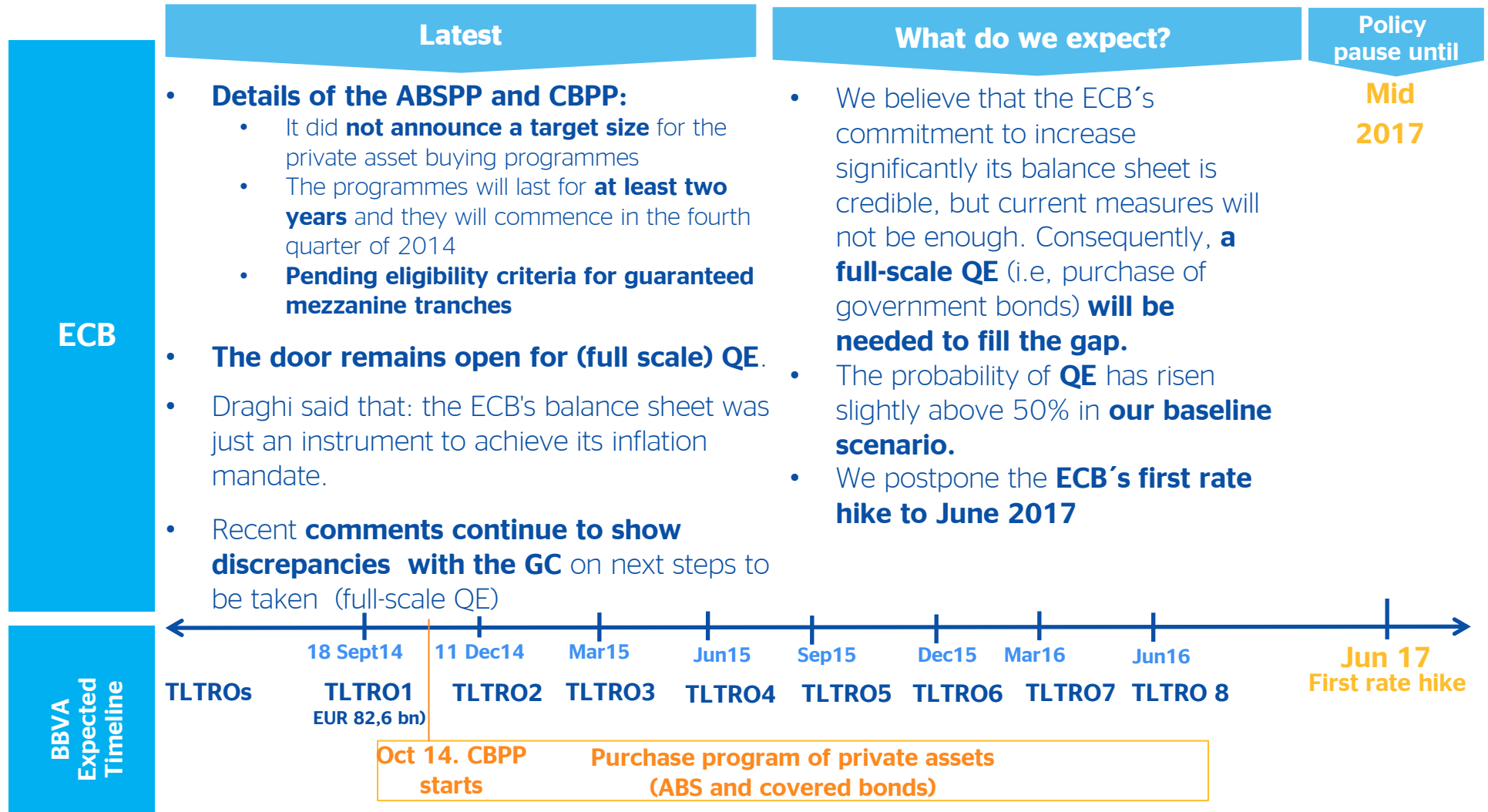
Source BBVA Research



6) ECB: how to increase significantly its balance sheet? Running out of options



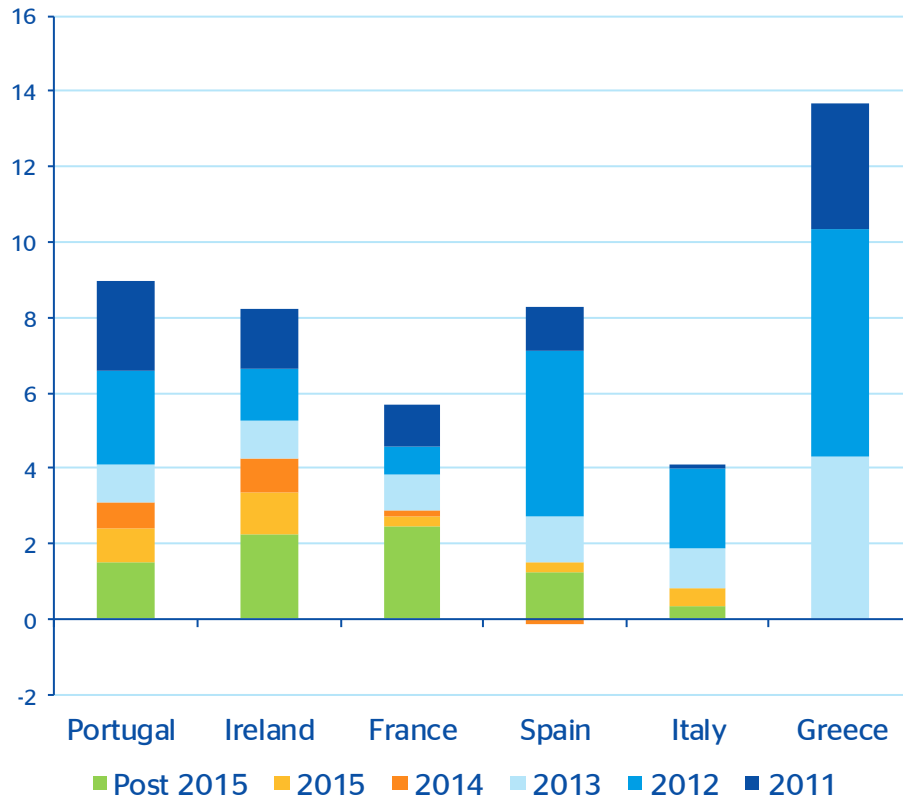
6) The ECB in a wait and see stance



7) Fiscal policy is less restrictive than in previous years...

Structural deficit adjustment 2010-2015 (% GDP)

Source: BBVA Research



The adjustment of the structural deficit will be lower in 2014 than in previous years

The structural deficit after 2015 will remain positive and need further adjustment to meet the fiscal rules

Intense debate on fiscal policy:

1. Room for Germany
2. Deficit in France and Italy
3. Junker's plan on infrastructures

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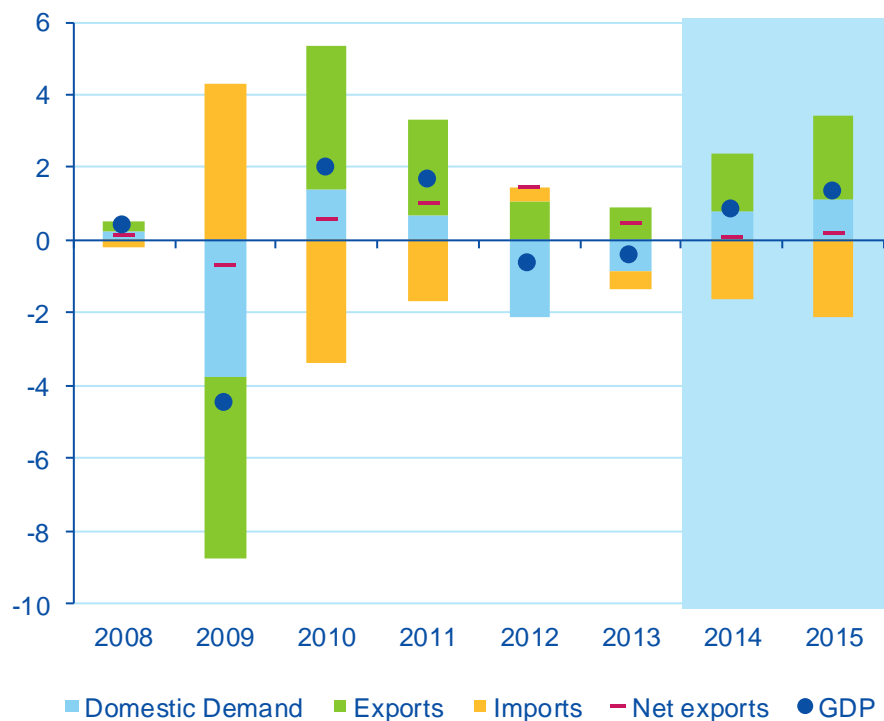
Annex

Country breakdown

Forecast: weaker than expected growth both in 2014 and 2015

EMU: annual GDP growth contributions (pp)

Sources: Eurostat and BBVA Research



	2012	2013	2014 (f)	2015 (f)
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Activity

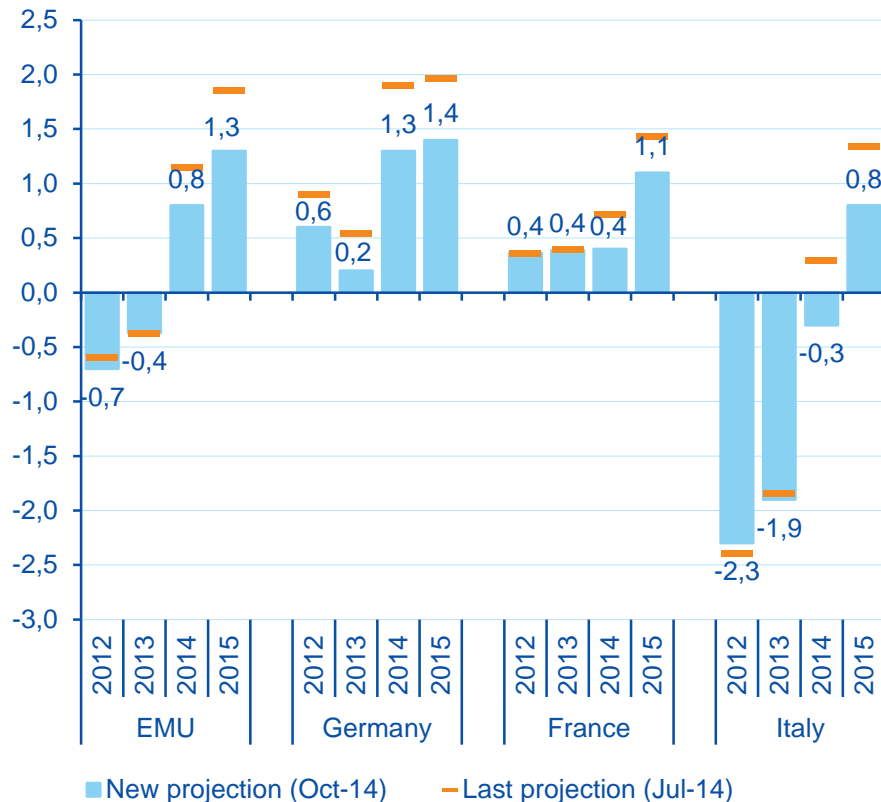
REAL GDP (% YoY)	-0,7	-0,4	0,8	1,3
Private consumption	-1,3	-0,6	0,7	1,3
Public consumption	-0,2	0,2	0,9	0,4
Investment	-3,2	-2,4	0,6	1,8
Domestic demand (contr. %)	-2,1	-0,8	0,8	1,1
Exports	2,6	1,1	3,7	5,1
Imports	-1,0	1,2	4,1	5,2
Net exports (contr. %)	1,4	0,4	0,0	0,2

Current account balance(% GDP)	1,2	2,3	2,2	2,1
Public deficit (% GDP)	-3,6	-2,9	-2,8	-2,6
CPI, % average	2,5	1,4	0,5	1,0

By country: downward revisions in the three largest countries

GDP forecast by country (%)

Sources: Eurostat and BBVA Research



- Germany continues to lead the recovery but with downward revision

- France doesn't gain momentum yet
- Recently, positive measures have been adopted to regain competitiveness and reduce public spending

- Italy: still in recession in 2014
- Extensive reform plans, that need to be materialized

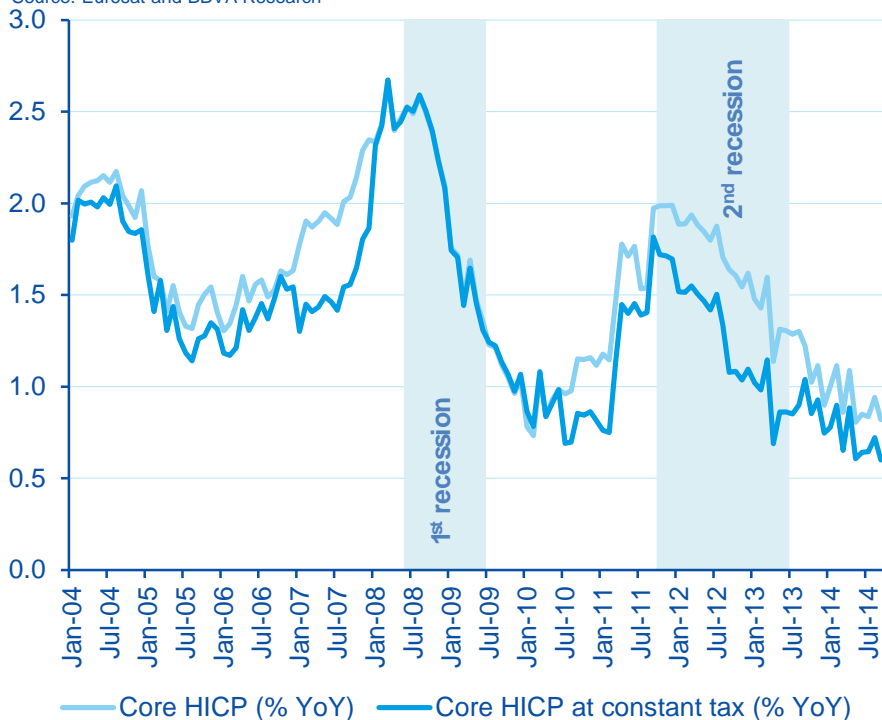
Inflation is expected to stay at very low rates

Inflation moderation over 3Q14 reflected falling prices of food and energy.
Core inflation broadly stable at low levels (0.8%)

Projected acceleration to only 1% due to the euro depreciation

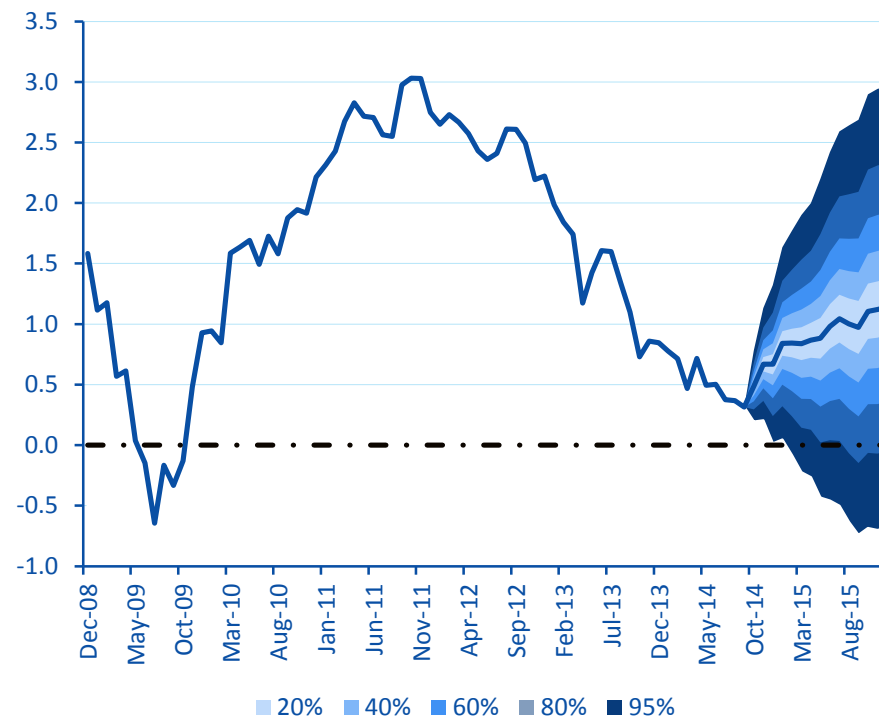
Eurozone: core inflation (% YoY)

Source: Eurostat and BBVA Research



Eurozone: inflation (% YoY)

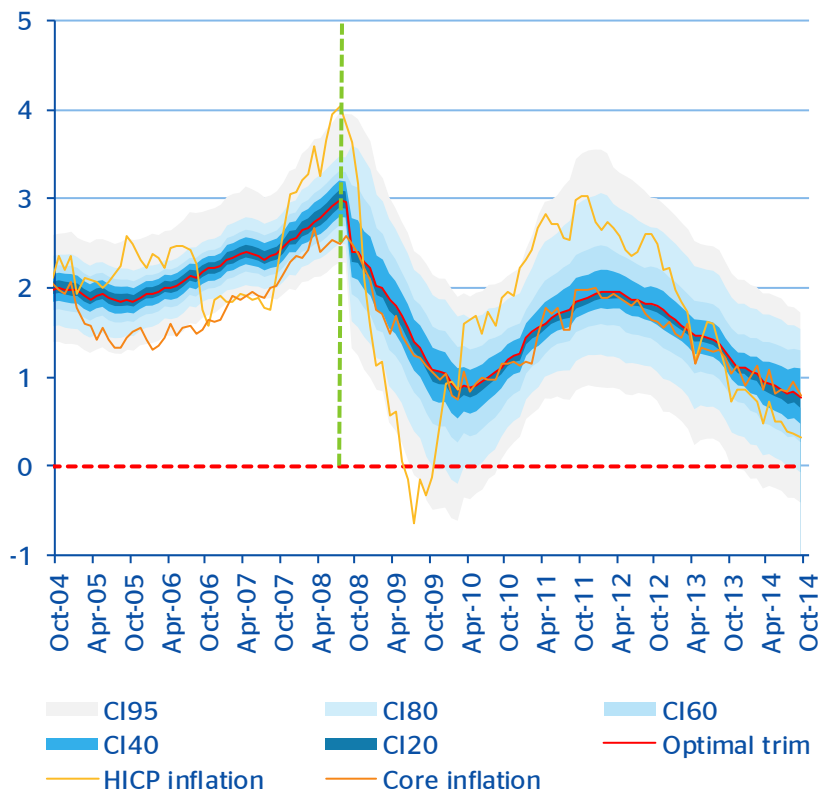
Sources: Eurostat and BBVA Research



Inflation expectations worsened, increasing the risk of de-anchoring

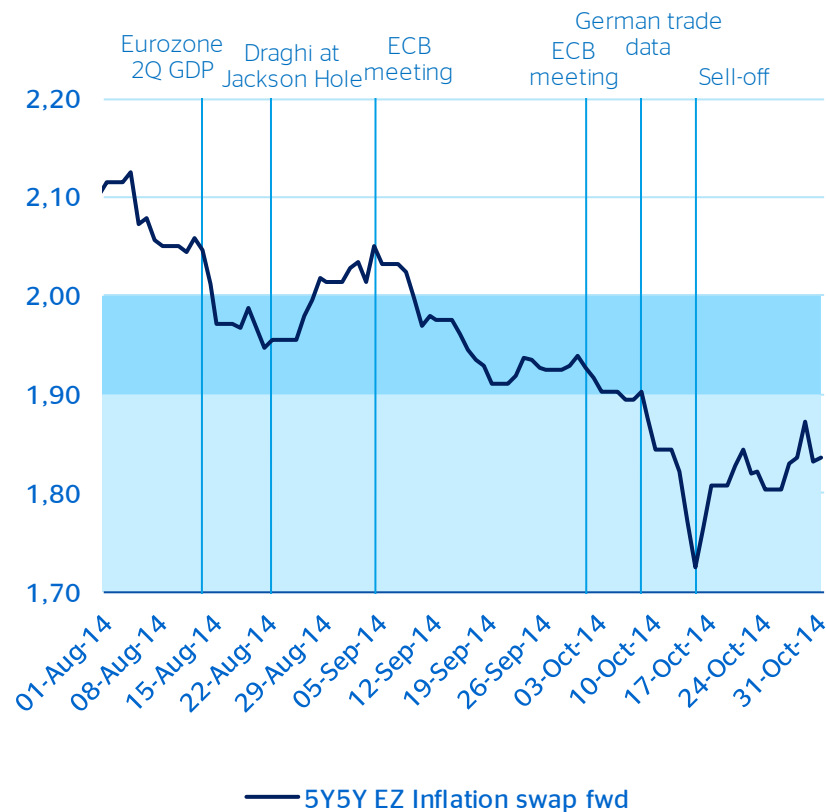
Eurozone: inflation (% YoY)

Source: BBVA Research



Eurozone: 5Y5Y inflation swaps

Source: BBVA Research








Risks

Old




New

External

- 1. Lower growth abroad (China) 
- 2. Impact from a problematic Fed exit 
- 3. Geopolitical risks 

- 1. Fed intolerance to dollar appreciation 
- 2. Prolonged conflict with Russia 

Domestic

- 1. AQR surprises 
- 2. Risk of deflation and the burden of a recovery with very low inflation 
- 3. Lack of effectiveness of ECB's measures and market reversion 

- 1. Rebound in confidence 
- 2. More activism in European authorities 
- 3. Further delays with reforms 
- 4. Political risks (Catalonia, Le Pen, etc) 
- 5. True secular stagnation 

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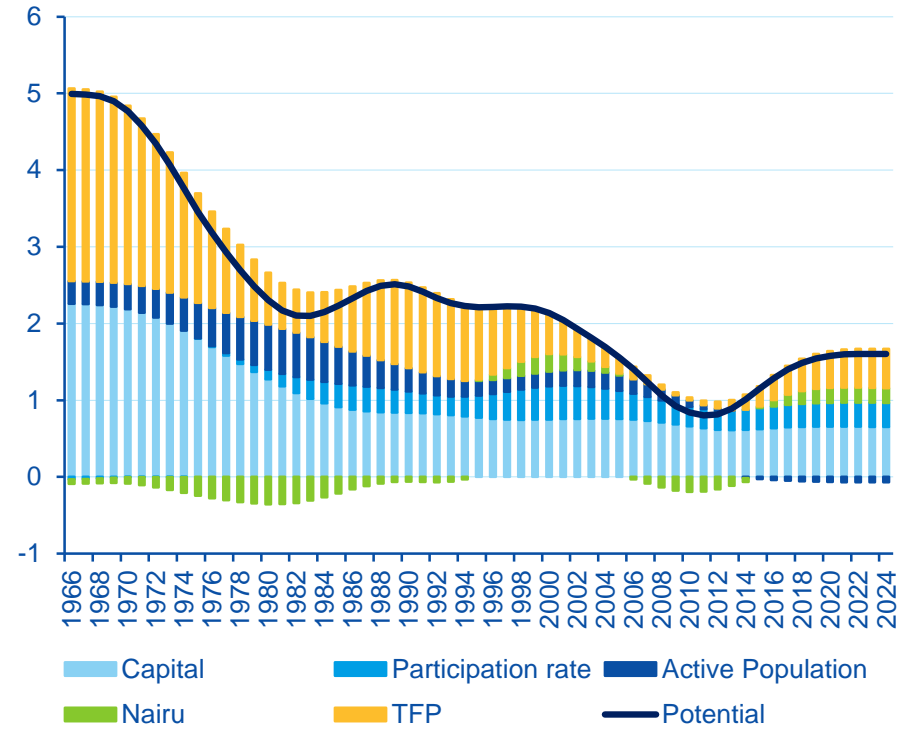
Country breakdown

Low potential growth

The crisis has reduced the potential below 1%, but should recover to 1.5%

Eurozone: potential GDP growth (%) and factors' contribution (pp)

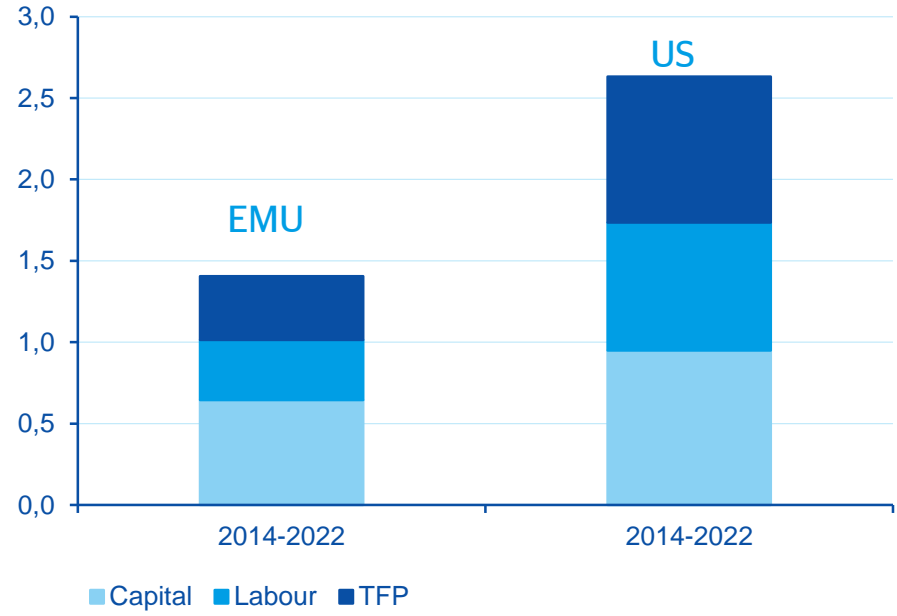
Sources: Eurostat and BBVA Research



Lower potential than in US

US and EZ projected potential GDP growth (pp)

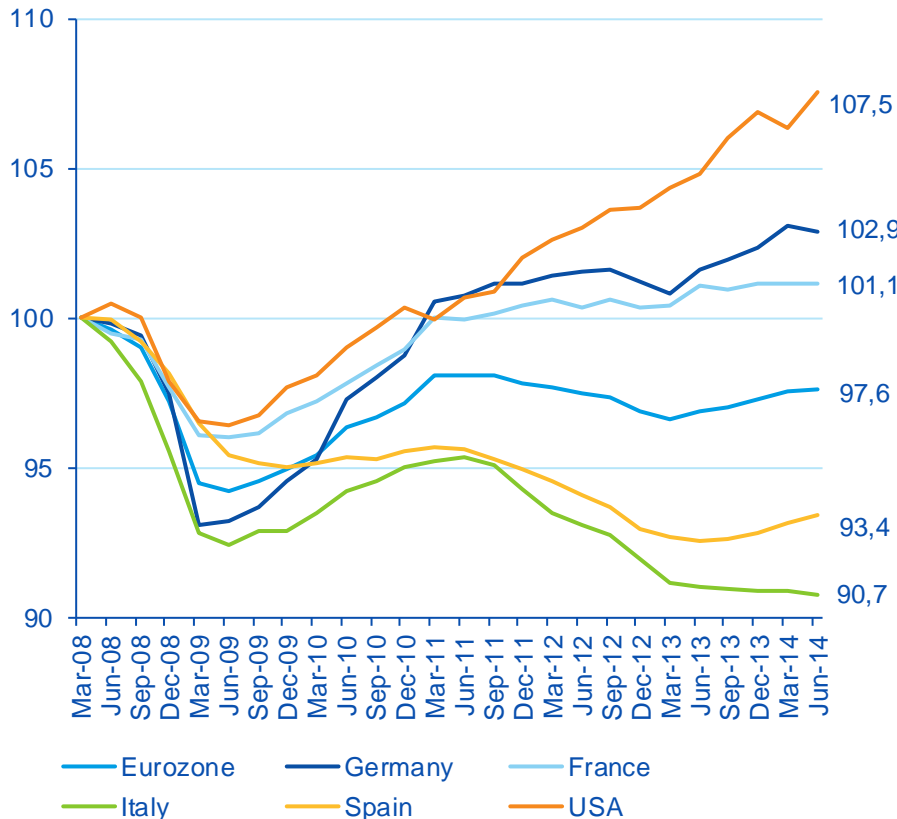
Sources: Eurostat and BBVA Research



The impact of the crisis: US vs core vs periphery

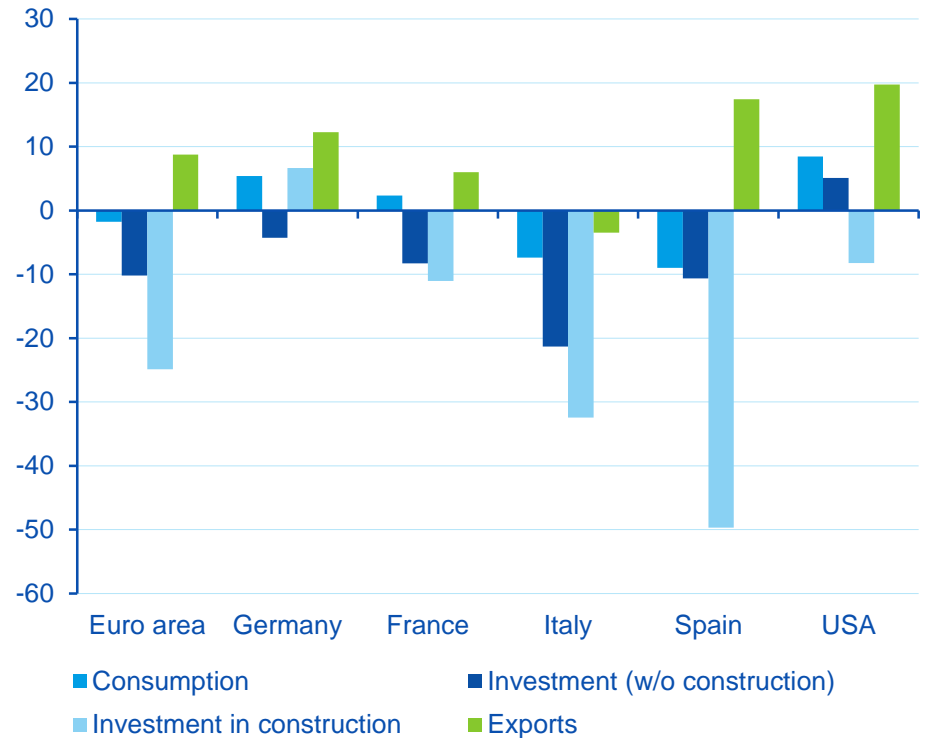
GDP

Note: Q1-2008=100
Sources: Eurostat, Haver and BBVA Research



Components

Note: Q1-2008=100
Sources: Eurostat, Haver and BBVA Research



Heat map of macroeconomic imbalances

	Public Debt	Public Deficit*	Unemployment Rate	Current Account	Net International Investment Position	Real Effective Exchange Rate	Nominal Unit Labour Cost	Household Debt	Non-Financial Corporations Debt
	% of GDP	% of GDP		% of GDP	% of GDP	3-yr % chg.	3-yr % chg.	% of GDP	% of GDP
	Q4-2013	2013	Latest	2013	Q4-2013**	Sep. 2013	Latest	Latest	Latest
Eurozone	92,7	-2,8	11,8	2,4	-12,2	1,0	3,9	63,9	81,5
GER	78,4	0,0	5,1	7,5	48,3	0,1	6,1	58,2	48,5
FRA	93,5	-4,3	10,4	-1,4	-21,2	-0,7	5,2	56,7	84,0
AUT	74,5	-0,9	4,9	2,7	3,4	2,2	7,3	54,5	92,9
BEL	101,5	-2,8	8,5	-1,6	44,0	0,5	8,6	56,5	92,4
NED	73,5	-2,5	7,2	10,4	53,0	1,5	6,4	127,9	91,5
FIN	57,0	-2,1	8,5	-1,1	15,8	1,9	8,5	65,4	92,5
ITA	132,6	-3,1	12,7	1,0	-30,0	2,0	4,3	45,3	81,0
SPA	93,9	-6,6	25,3	0,8	-98,2	0,8	-5,3	81,3	114,0
POR	129,0	-4,5	15,2	0,5	-118,7	0,2	-1,3	86,8	130,8
IRE	123,7	-6,7	11,8	6,6	-104,9	-2,4	-3,4	105,1	201,3
GRC	175,1	-2,1	26,5	0,7	-119,0	-3,9	-11,1	64,5	64,8
DEN	44,5	-0,9	6,5	7,3	39,6	-1,4	3,8	139,2	97,9
SWE	40,6	-1,1	8,1	6,2	-4,8	3,1	6,2	83,4	121,2
U.K.	90,6	-5,7	6,7	-4,4	-1,3	3,9	6,2	93,1	83,8

Colour criterion:

Higher than 130	Lower than -6	Higher than 16	Lower than -6	Lower than -100	Greater than 6	Greater than 9	Greater than 110	Greater than 140
110/130	-6/5	13/16	-6/-4	-100/-50	4/6	6/9	90/110	120/140
90/110	-5/-4	10/13	-4/-2	-50/0	2/4	3/6	75/90	100/120
60/90	-4/-3	7/10	-2/0	0/20	0/2	0/3	60/75	80/100
Lower than 60	Higher than -3	Lower than 7	Greater than 0	Greater than 20	Lower than 0	Lower than 0	Lower than 60	Lower than 80

Excluding aid to the financial sector

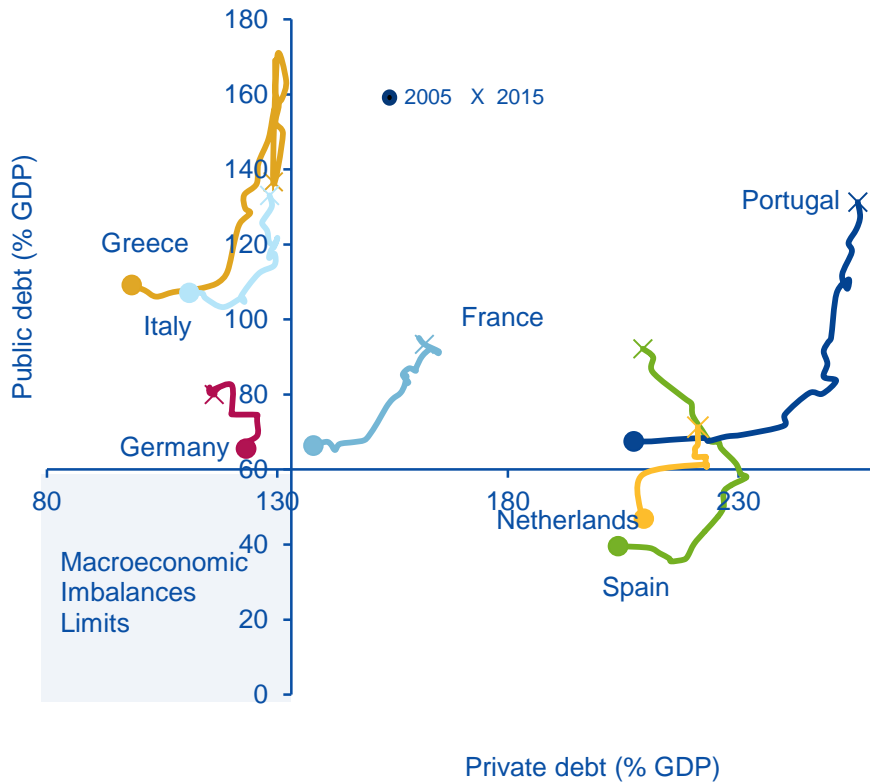
**Data for France: 4Q-2012

Source: Eurostat, BCE, Haver and BBVA Research

Deleveraging isn't in process yet, with exceptions

Public and private debt 2005-2015 (% GDP)

Sources: Eurostat and BBVA Research



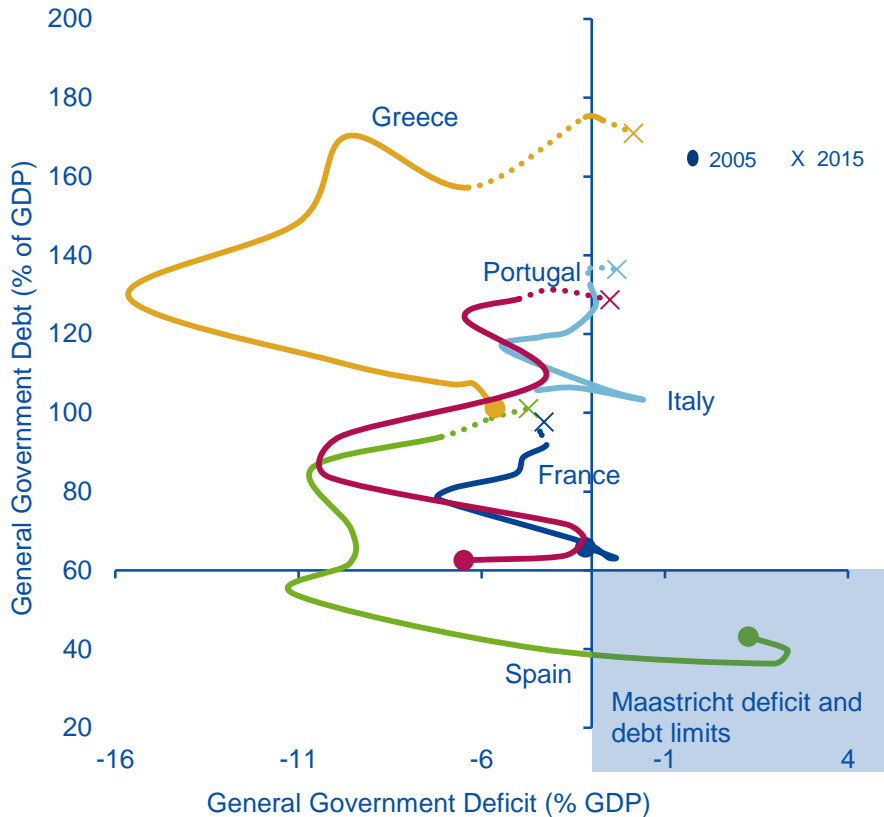
Private debt has stabilized and begun to fall in Spain

The peripheral countries have experienced much larger increases in debt than the core during the crisis

Peripheral countries have reduced public deficits but public debts continue to grow

Government debt and deficit 2005–2015

Source: FMI



The adjustment of the deficit has been huge, especially in the countries subject to the program

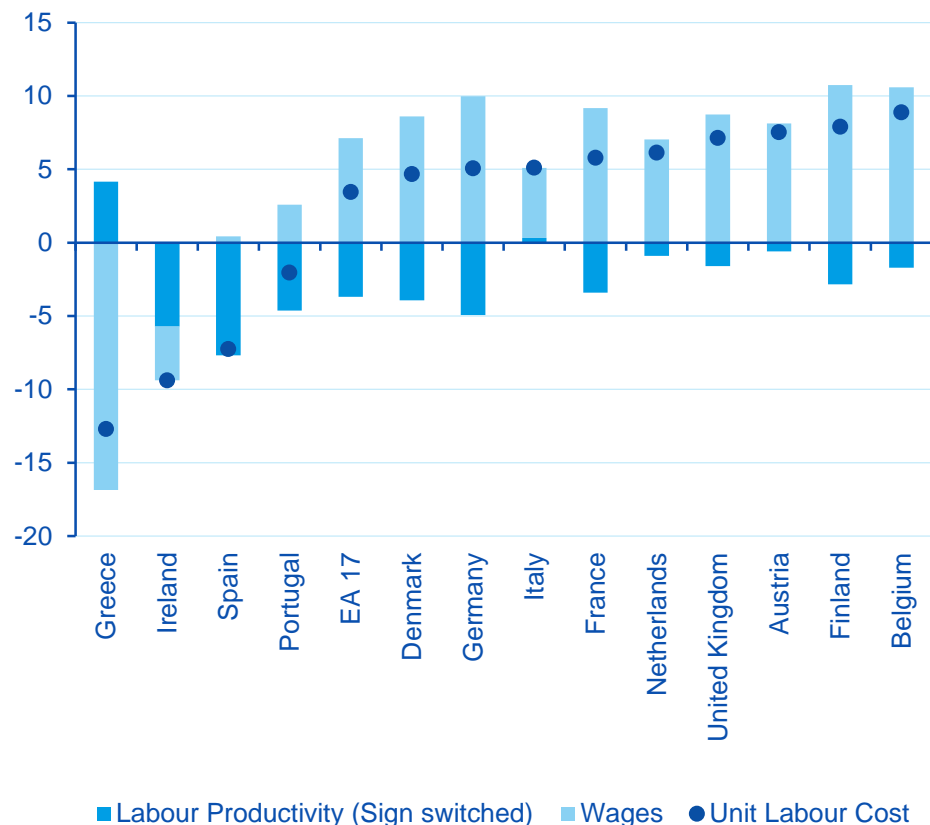
But debt levels have not begun to fall yet

The return to growth and higher inflation are key to rapid deleveraging

Unit labor costs have been adjusted rapidly in the periphery

Unit labour costs adjustment, 2009-2013 (%)

Sources: Haver y BBVA Research



In some countries this was due to increased productivity caused by the decline in employment

Wage moderation has also played an important role, especially in comparison with the core countries

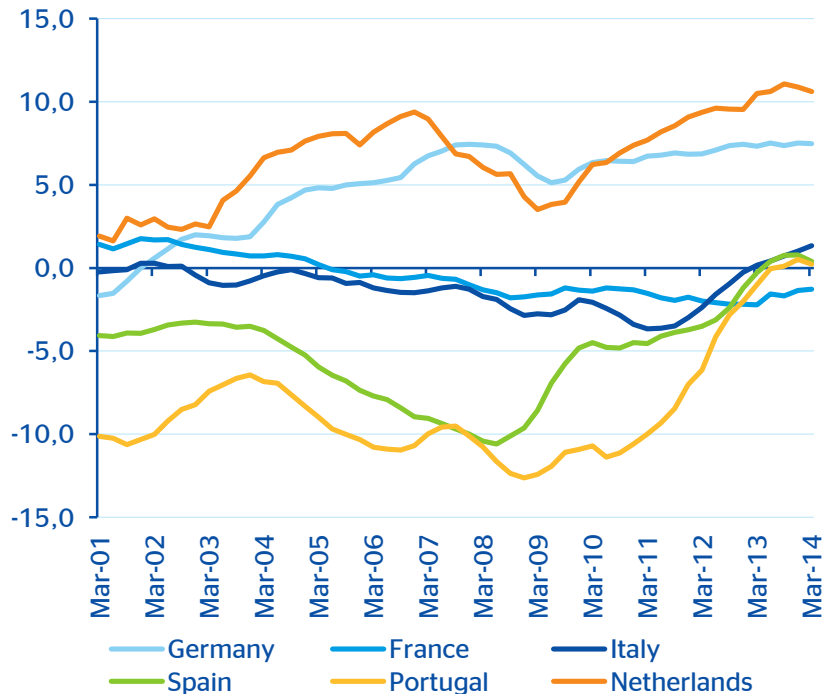
The current account deficits have disappeared very fast

Most countries in the euro zone are now in surplus (except for France)

Part of the adjustment is due to the recession (less imports), but exports have also played an important role

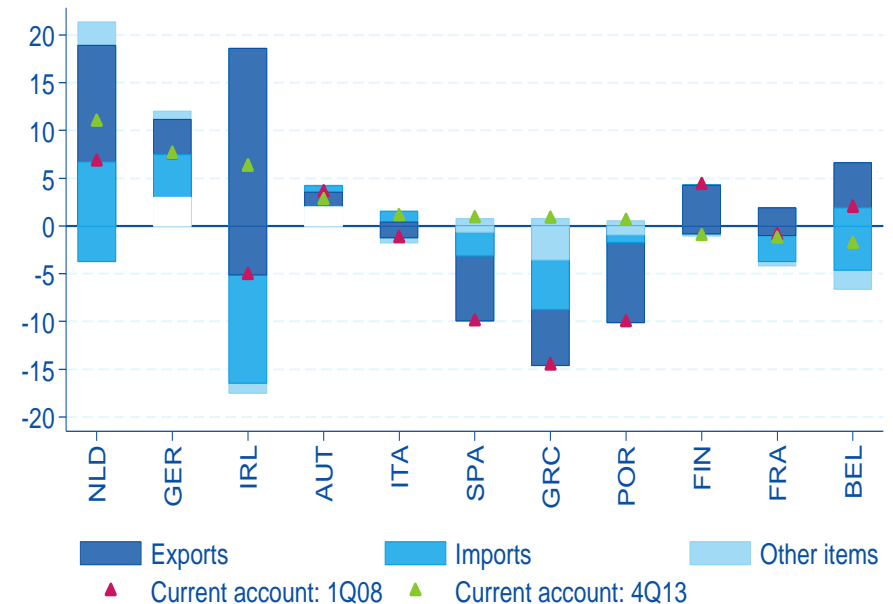
Current account (% GDP)

Sources: Eurostat and BBVA Research



Current account (% GDP)

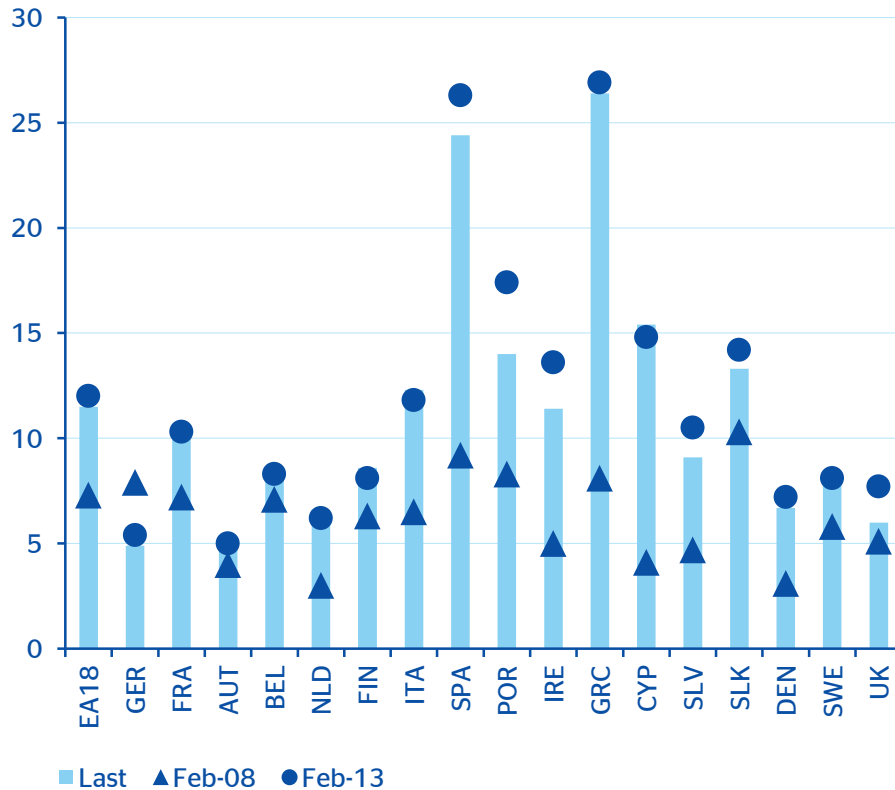
Sources: Eurostat and BBVA Research



The high unemployment remains the main problem of economic policy

Unemployment since the beginning of the crisis (%)

Sources: Haver and BBVA Research



The unemployment rate is well above that of 2008 (except in Germany)

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

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Section 1

Slow motion recovery and bumpy road ahead

Section 2

The drivers of growth: further policy measures to prevent headwinds

Section 3

Forecast: downward revision

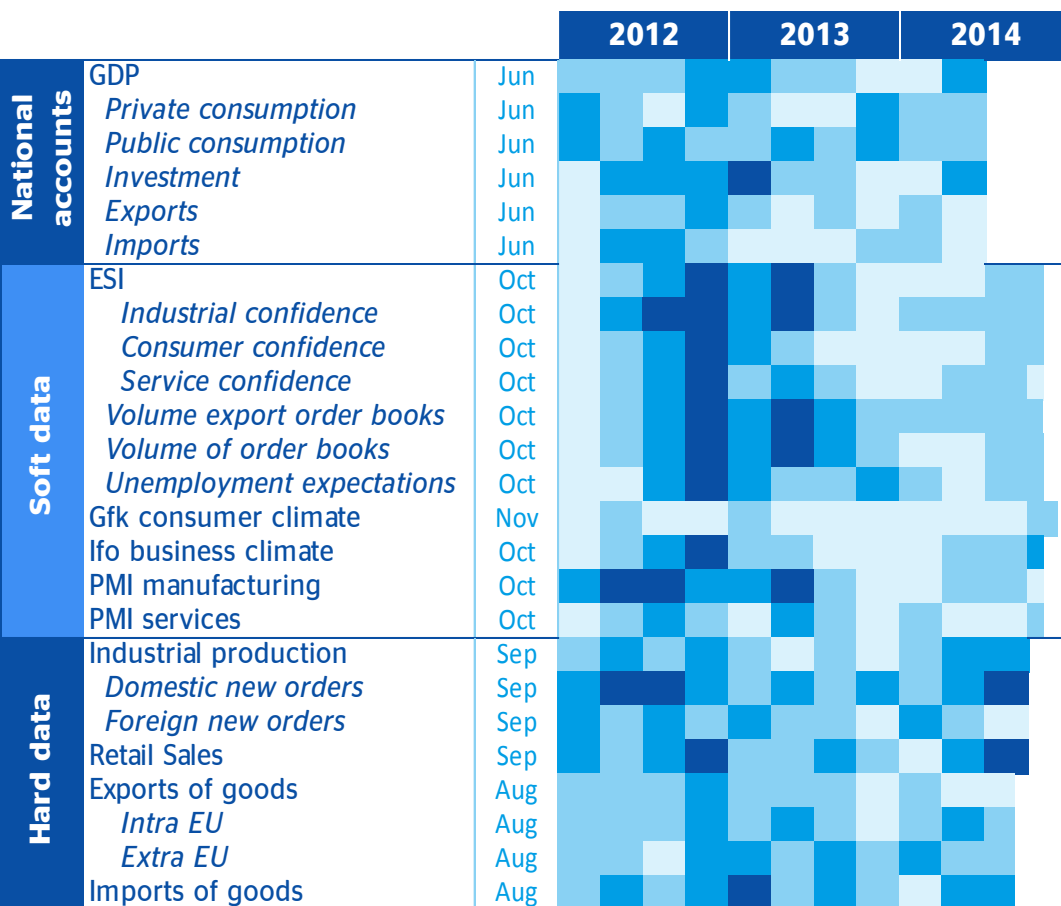
Section 4

Some imbalances have been corrected, but the growth potential is reduced

Annex

Country breakdown

Germany: deterioration in the industrial sector 3Q14



Confidence indicators worsened over 3Q14

International conflicts have affected companies' propensity to investment

	2012	2013	2014 (f)	2015 (f)
Activity				
REAL GDP (% YoY)	0,6	0,2	1,3	1,4
Private consumption	0,6	0,9	1,2	1,3
Public consumption	1,2	0,7	1,1	0,9
Investment	0,1	-0,6	3,2	3,3
Domestic demand (contr. %)	-0,8	0,7	1,5	1,5
Exports	3,5	1,7	3,4	4,1
Imports	0,4	3,2	4,3	4,9
Net exports (contr. %)	1,4	-0,5	-0,1	0,0
External sector				
Current account balance (% GDP)	7,2	7,3	6,7	7,1
Public finances				
General Govt. Balance (% GDP)	0,1	0,1	0,0	0,0
Prices				
CPI, % avg.	2,1	1,6	0,9	1,5

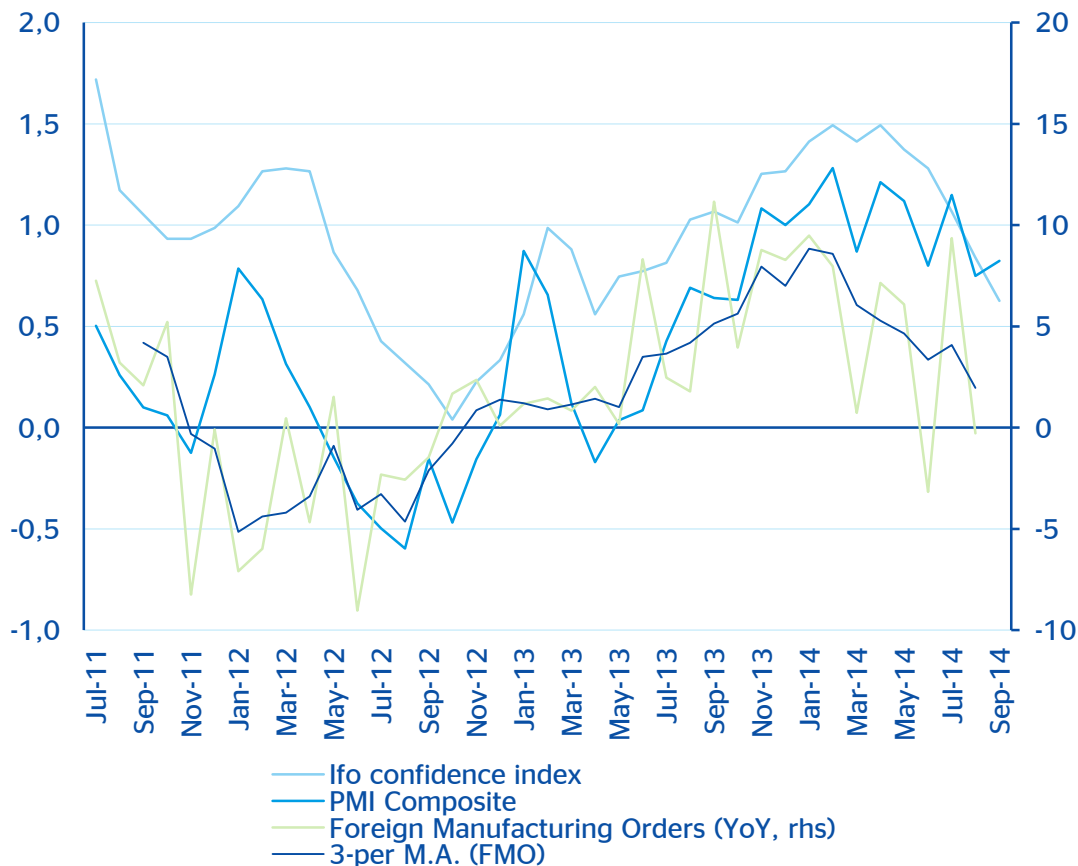
Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken. For confidence data, standardized values are used, and the growth and fall are related to the mean.



Germany: slower growth with medium-term concerns

Ifo confidence, composite PMI and manufacturing orders from abroad

Source: BBVA Research

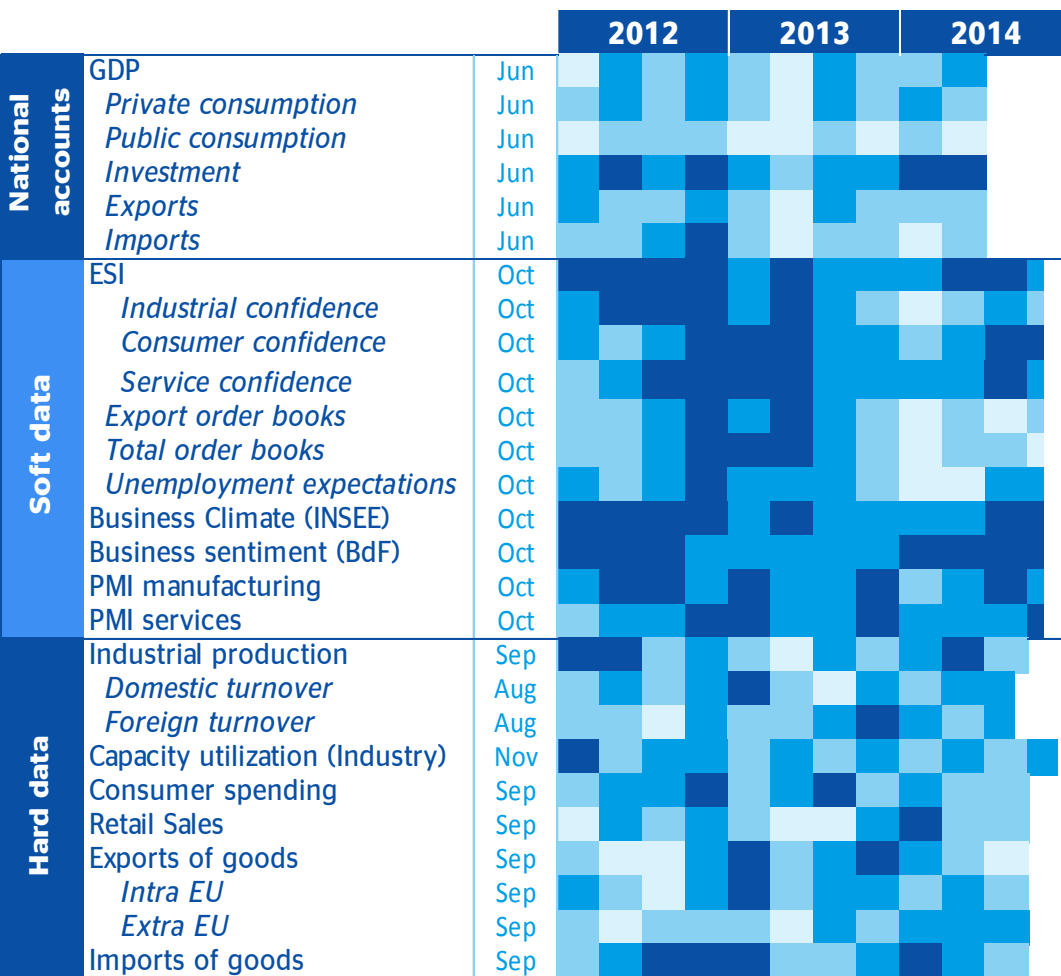


Growth continues but at a slower pace than initially expected

Private consumption does not grow at rates consistent with the favorable labor market conditions

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

France: recovery doesn't gain momentum



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken. For confidence data, standardized values are used, and the growth and fall are related to the mean.

No DATA
Stronger growth
Growth
Fall
Deeper fall

Confidence indicators fell sharply in Q3

Domestic demand continues to sustain the slow recovery

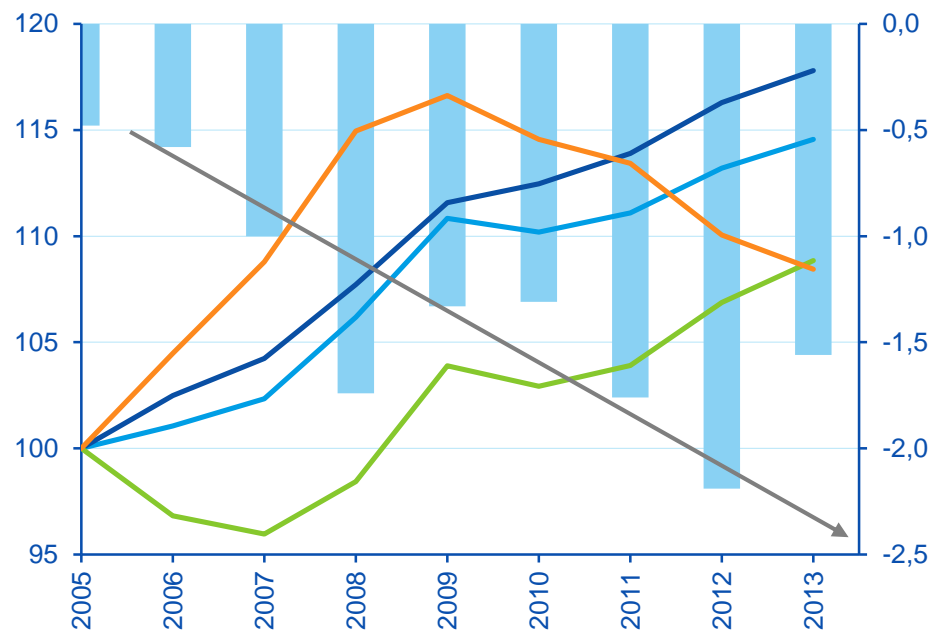
	2012	2013	2014 (f)	2015 (f)
Activity				
REAL GDP (% YoY)	0,4	0,4	0,4	1,1
Private consumption	-0,4	0,3	0,2	1,1
Public consumption	1,7	2,0	1,7	0,5
Investment	0,3	-0,8	-0,6	1,1
Domestic demand (contr. %)	-0,3	0,3	0,4	0,9
Exports	1,2	2,4	2,6	3,2
Imports	-1,2	1,9	2,5	2,6
Net exports (contr. %)	0,7	0,1	0,0	0,1
External sector				
Current account balance (% GDP)	-2,1	-1,3	-1,7	-1,6
Public finances				
General Govt. Balance (% GDP)	-4,9	-4,1	-4,4	-4,3
Prices				
CPI, % avg.	2,2	1,0	0,7	0,9

France: political instability slows reform process

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

Note: Unit labour costs normalized to 100 in 2005

Source: BBVA Research



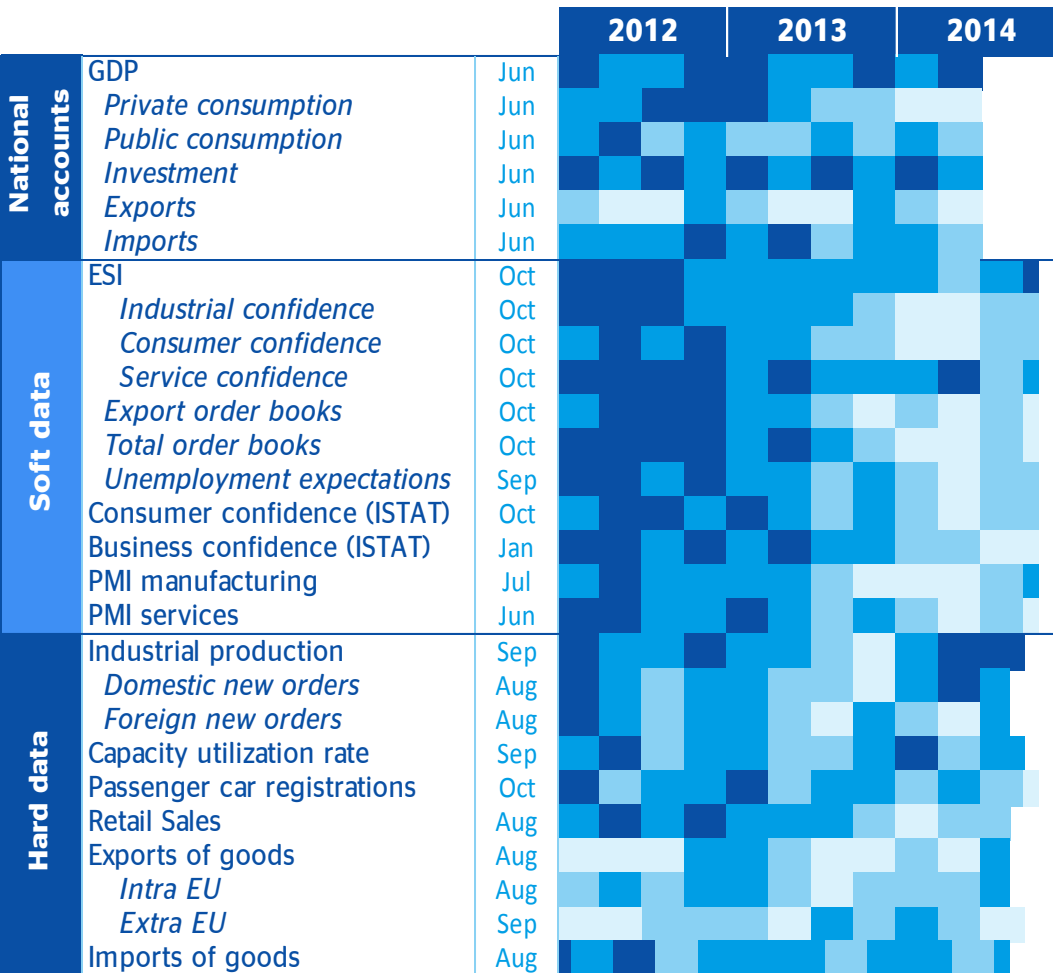
- FRA Current Acc. Balance (%GDP) RHS
- Eurozone
- France
- Germany
- Spain

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

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

But the government is negotiating to ease fiscal consolidation

Italy: the recession continues in 2014



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken. For confidence data, standardized values are used, and the growth and fall are related to the mean.

No DATA
Stronger growth
Growth
Fall
Deeper fall

Last confidence indicators have clearly worsened

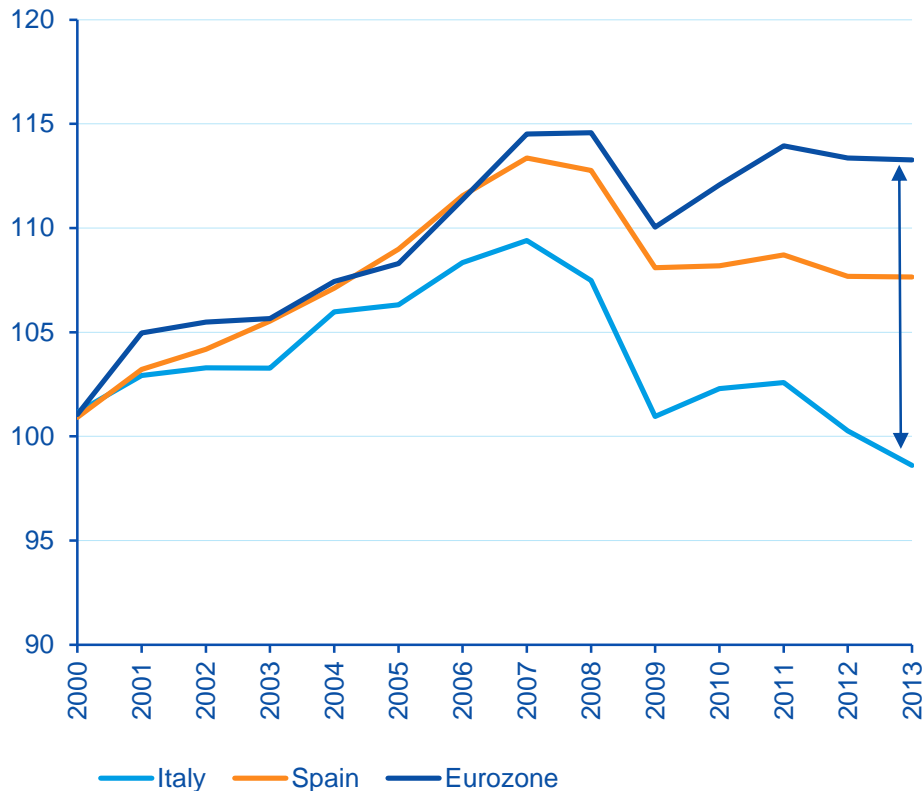
Net exports no longer support the weak recovery

	2012	2013	2014 (f)	2015 (f)
Activity				
REAL GDP (% YoY)	-2,3	-1,9	-0,3	0,8
Private consumption	-4,1	-2,7	0,0	0,5
Public consumption	-1,5	-0,7	0,0	-0,3
Investment	-7,5	-5,4	-2,1	1,5
Domestic demand (contr. %)	-5,0	-2,8	-0,4	0,6
Exports	1,6	0,9	2,0	3,8
Imports	-8,2	-2,6	1,6	3,4
Net exports (contr. %)	2,6	0,9	0,2	0,3
External sector				
Current account balance (% GDP)	-0,2	1,0	0,9	0,9
Public finances				
General Govt. Balance (% GDP)	-3,0	-2,8	-3,0	-2,7
Prices				
CPI, % avg.	3,3	1,3	0,3	0,7

Italy: reforms needed to increase the growth potential

GDP/working age population (2000=100)

Source: BBVA Research

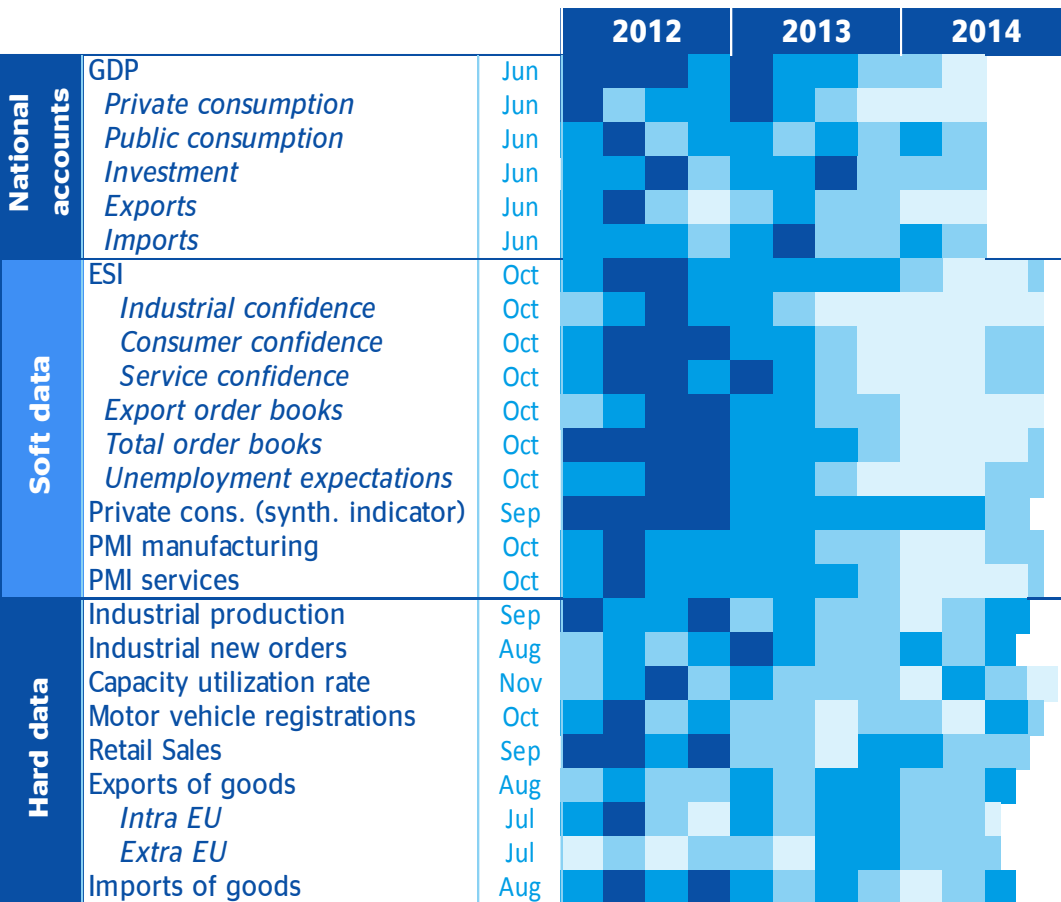


In fiscal policy, the main problem is the high volume of public debt (132.6%), while the deficit reduction is slower than expected

The growth potential is very slow ...

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

Spain: recovery at a healthy pace



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken.

For soft data, standardized values are used, and the growth and fall are related to the mean.

No DATA
Stronger growth
Growth
Fall
Deeper fall

The growth will be driven by domestic and external factors, despite the lack of dynamism in European demand

The trend in recent data points to a practical stabilization of growth around 0.5% in 3Q14

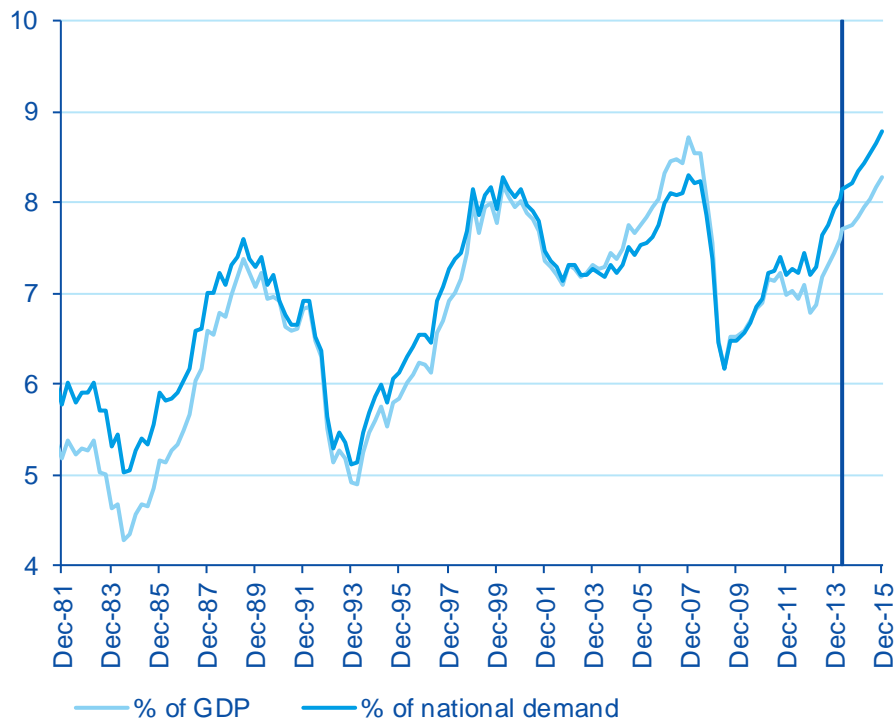
	2012	2013	2014 (f)	2015 (f)
Activity				
REAL GDP (% YoY)	-2,1	-1,2	1,3	2,0
Private consumption	-3,0	-2,3	2,1	1,8
Public consumption	-3,7	-2,9	1,0	0,9
Investment	-8,3	-3,7	0,7	4,2
Domestic demand (contr. %)	-4,3	-2,7	1,6	2,0
Exports	1,2	4,3	3,7	5,3
Imports	-6,3	-0,5	4,8	5,0
Net exports (contr. %)	2,5	1,5	0,0	5,5
External sector				
Current account balance (% GDP)	-0,3	1,4	1,2	2,1
Public finances				
General Govt. Balance (% GDP)	-6,6	-6,3	-5,5	-4,2
Prices				
CPI, % avg.	2,4	1,4	0,0	1,0

Spain: improvement in the labor market, but major imbalances persist

Spain: Investment in machinery & equipment

(Real ratios, 2008 prices)

Source: BBVA Research from INE



The recent increase in investment in machinery and equipment is consistent with the change in the production model oriented to the external sector

The most urgent and important challenge is the sustained job creation, of the highest quality possible

Need to take measures to improve productivity, competitiveness and human and technological capital, among others