Europe

Economic Outlook

Third Quarter 2010

Economic Analysis

- The main risk to the European outlook is still coming from financial markets.
- There have been some progresses with the publication of stress tests, although bank restructuring is far from complete.
- After the good performance in the first two quarters of 2010, we expect a slowdown in activity during the second half and mild growth in 2011.
- Fiscal policy: well designed austerity plans can limit their effect on activity.

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Closing date: August 3, 2010

1. Reassessing the risks for the global economy

The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed

Medium-term risks from unsustainable fiscal positions in other developed regions are probably being underestimated. As shown below in section 4, consolidation plans in Europe are being widely implemented and a positive factor is that the planned adjustment is fast and tilted towards reducing expenditure, which will boost confidence and almost compensate the negative effect on growth from reduced public demand. Other advanced economies like the US, where fiscal impulses have been substantial and debt levels have increased at a pace similar to that in Europe, are relatively slow in coming to grips with reducing deficits and –at least– stabilizing debt levels. This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates is highly non-linear, and there is a risk of sudden increase in long-term rates and a displacement of private demand; exactly the opposite effect intended by the fiscal stimulus packages.

The main risk to the global outlook is still coming from financial markets

Although risks have been reduced the potential fallout from renewed tensions is still sizable. Financial risks, which stemmed from sovereign debt concerns, formed a feedback loop that ended up increasing market risk and drying up liquidity, especially in Europe. Nonetheless the sharp increase in financial tensions in the second quarter is starting to abate (see Chart 1), in part due to the release of European stress tests results Nonetheless the risk to the global economy coming from financial markets is still the main source of concern.

Increasing divergence in monetary policy strategies

Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America. Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period. Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies. Nonetheless, a faster recovery in the US will mean that the monetary exit will be earlier there than in Europe. On the other hand, in emerging economies monetary tightening is resuming, after a pause (especially in Asia) as the European debt crisis unfolded. This will help reduce inflationary pressures in Asia –where they were starting to build– and prevent potential pressures from developing later in the year in South America. An important exception is Banco de México, likely to hold rates until the second quarter of 2011.

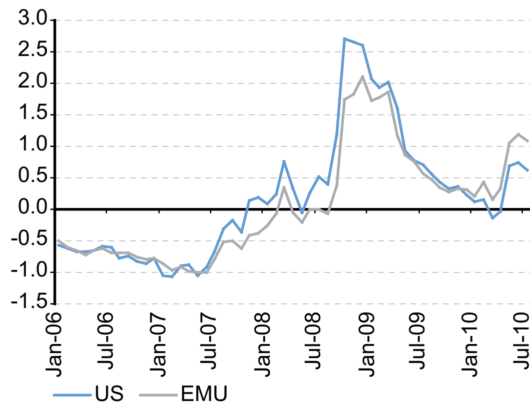
The global economy is on track for a mild and differentiated slowdown

In China and elsewhere in Asia, a moderating growth trend should reduce the risks of overheating. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis. Spillovers from the European financial crisis to other geographical zones have been relatively limited. Nonetheless, the global economy will slow down going forward (see Chart 2). In the US, the recovery is likely to lose momentum on account of softening labor and housing markets. This shows the limits of private demand taking over as an autonomous driver of growth. In China, slowing GDP growth in the second quarter and moderating activity indicators are evidence that the authorities' tightening measures are being effective to steer the economy toward a soft landing in the second half of the year. Latin America will also slow down in 2011, but keep robust growth rates going forward. Therefore divergences with continue to widen both between advanced and emerging economies and within each of those groups.

Although there were some steps in the right direction, going forward the necessary global rebalancing of demand and the narrowing of global imbalances is still pending

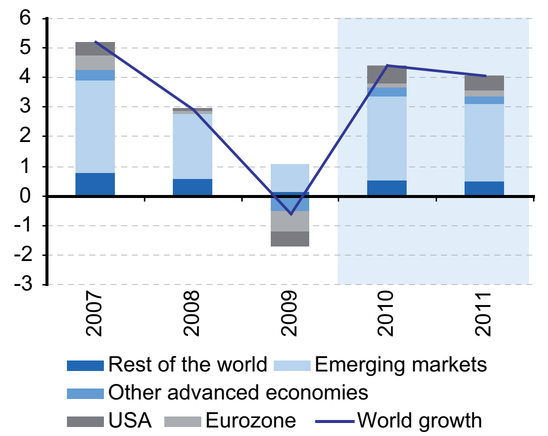
The medium-term rebalancing of the Chinese economy towards more internal demand (particularly consumption) has begun, and the recent renewal of currency flexibility should help. However, further reforms are needed to help boost consumption toward regional levels. Other advanced surplus countries also need to implement reforms to increase domestic demand, most notably in the service sector. On the other hand, the US and other countries with substantial external financing needs need to switch from a consumption-led growth model to investment, especially in tradable sectors. The recent financial crisis has shown the limits to foreign financing of growth. Economies with high external financing needs are highly vulnerable to an upsurge of international financial tensions, and the resulting sudden movements in exchange rates risk undermining global financial stability.

Chart 1
Financial Stress Index*



* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets
Source: BBVA Research

Chart 2
Contributions to Global GDP growth



Source: BBVA Research based on national accounts

2. Forces shaping the recovery

As shown in the previous section, the shape of the global recovery is partly determined by what is happening in Europe, as the sovereign crisis that has taken place as from this spring, together with the uncertainty created at a global level, and the associated depreciation of the euro and central events in the global outlook. More specifically for Europe, this section reviews the key forces behind the outlook for the Eurozone economy, which are broadly the same as spelled out in the previous issues of this publication, but have nonetheless evolved somewhat over the last two months.

End of fiscal stimulus and consolidation, broadly as planned

Here the news is no major news, and therefore good news. That is, fiscal austerity plans as designed at the end of last year by national authorities and approved by Brussels are being fulfilled with budget discussions for 2011, which have been in the news over the past quarter. France, Germany and Italy have presented a range of fiscal measures, still under discussion, that have to be implemented in detail and do not change deficit targets. In this sense, despite all the repercussions in the media, there is no additional tightening. Spain, Portugal and now (outside the area) the United Kingdom, have accelerated their consolidation effort and frontload them, in line with markets' demands of more rapid consolidation. The equilibrium between the need of adjustment to reduce deficit ratios and the need to avoid a sharp contraction is about right, and clearly differentiated across countries, as it should be given the different starting points. As shown in section 4, we calculate that the impact of these plans on activity is likely to be small, but still negative, and therefore fiscal retrenchment will act as a downward force in the recovery.

Sovereign crisis to impact growth, but with positive news

As noted in section 1, the sovereign crisis that has hit several eurozone countries since May increased financial stress, although the situation has improved very recently after the publication of stress tests. We consider however, that the situation is far from being normalized, and expect further progress for the coming three months. Still, the impact on confidence, risk aversion and the liquidity situation of companies and financial institutions in several euro area countries is likely to have an impact on growth in the second half of the year and is one of the main factors behind the deceleration we foresee for that period.

Some progress in the restructuring in the financial system

This factor is being addressed after the publication of the stress tests (notably in Spain), but remains an issue in other countries in the area. The weakness of the financial system is mostly a medium term issue, since although not necessarily affecting activity in the short run, risks deriving in a “Japanese style” situation whereby weak banks are unprepared to provide enough finance to the economy. Money and credit aggregates have recovered only very slightly in Europe (and only for mortgages), and remain basically flat. Without recapitalization and the ability to provide credit, a durable recovery will not be possible in the area.

Euro depreciation partially reverted, but only temporarily

The exchange rate of the euro versus the dollar has recovered somewhat over the last month and a half, and now is close to 1.30 after having hit 1.20. Still, our projection continues to be that the equilibrium level of the euro is somewhere between 1.10 and 1.25, and that it should not drift much from those levels. Indeed, the very recent appreciation obeys more to relatively better data in Europe than in the U.S. at the end of the second quarter, but it does not respond to fundamentals. A low level for the euro will continue to play in favour of exports. On our calculations, the depreciation of the euro since the start of the year implies higher growth of about 0.4% in 2010 and 0.8% in 2011 (due to delayed effects).

Ongoing debate on institutional reforms in Europe

There is not much new here. An eventual reform of eurozone fiscal policy and governance structures will be analyzed in October by the Van Rompuy task force, and could positively affect growth if it provides a viable solution to fiscal coordination in Europe while ensuring that future financial crisis do not damage the credibility of the euro, as it has happened with the Greek crisis. There have been proposals in this respect (by the ECB, the European Commission and the French and German governments) which all go in the line for enforcing surveillance of road imbalances, coordination and sanctions, but the key issue of a crisis resolution regime has not fully been addressed yet.

3. Recent trends and projections

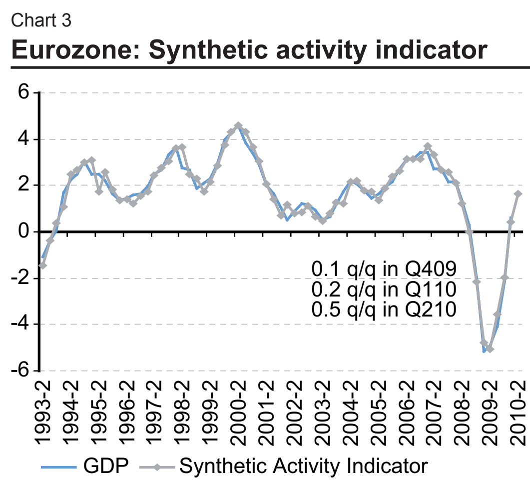
Eurozone economy will grow strongly in Q2, but several indicators suggest that the recovery is fading and it will slow in H2

Economic data available for Q2 show that the economic upturn has gained strength, while our synthetic economic activity indicator points to growth of around 0.5% q/q in the Euro area, after a mild improvement in previous quarters. For the coming months, the key question now is how sustainable the economic recovery is, and in this respect the relatively strong momentum of the last quarter could not be sustainable:

- First, confidence data have been easing since May, as well as other leading indicators such as industrial orders. Nevertheless, the uncertainty surrounding the economic outlook is very high. Indeed, economic sentiment from the PMI survey and from German Ifo data showed a surprising improvement in July, pointing to a better than expected start for the second half of the year after two months of weakness. It is however too early to draw any conclusions in this respect, as information is limited to soft data and the shape of the recovery will likely be determined by factors such as the impact of stress tests and measures applied by national governments to restructure the banking sector and achieve fiscal consolidation.
- Second, the recovery has been supported by temporary fiscal stimulus, which has started to be removed. In particular, peripheral countries such as Greece, Portugal and Spain have already implemented strong fiscal consolidation measures, while the rest of European countries will start applying austerity measures as from next year.
- Finally, the weakness of domestic demand has been partly offset by the strong inventory rebuilding process, but inventories are already close to normal levels.

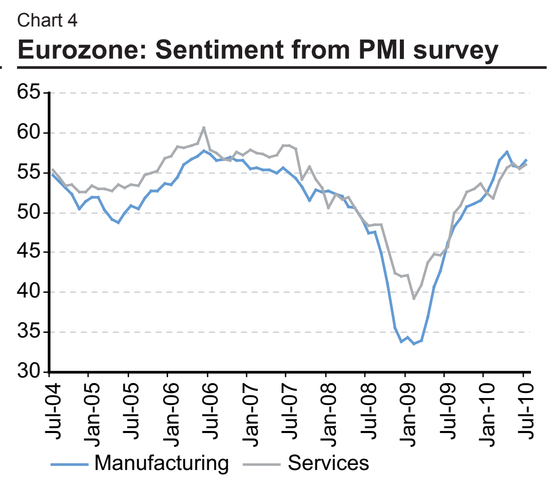
In short, the picture above suggests that economic growth will slow in the second half of the year, while external demand will be the key driver of the economy.

Chart 3
Eurozone: Synthetic activity indicator



Source:Eurostat and BBVA Research

Chart 4
Eurozone: Sentiment from PMI survey



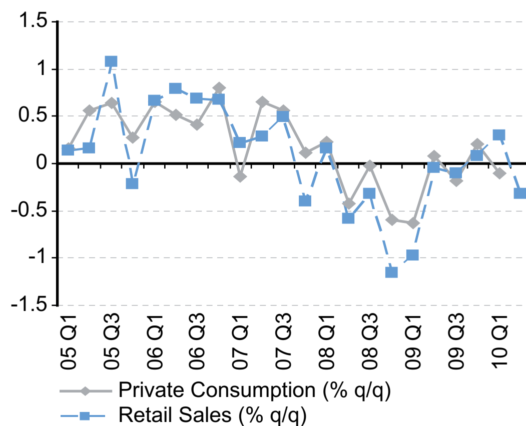
Source: Markit economics

Domestic demand is still subdued, with flat private consumption and a further fall in investment, while public consumption slows

Household spending showed no signs of recovery in the second quarter. Recent data showed that retail sales in the eurozone increased slightly in May, but without offsetting the fall recorded in April, and thus the level in these months remained slightly below the average observed in Q1, showing the weakness of private consumption in Q2 after declining by -0.1% q/q in the previous quarter. Underlying the weakness of household spending is the drop in disposable income, driven by job losses coupled with a moderate growth of wages, and only supported by lower inflation. The stabilization in the deterioration of the labour market, resulted in a slightly improvement in consumers' confidence in the last quarter of last year, although since then it has been stable at low levels, apart from a pick-up in July. The positive news from the improvement in confidence should be reflected in a reduction in the rate of precautionary savings, which was already noted in the last two quarters of 2009 (when the savings rate fell from 15.7% in Q2 to 15.1% in Q4, interrupting the upward trend observed since early 2008) and thus they should not result in lower consumer spending. It is also noticeable that both the end of fiscal incentives (such as vehicle scrapping schemes) and tax hikes on consumption (such as VAT in some countries) have lowered consumers' spending and could also have an impact in coming months due to frontloading purchases and a possible substitution effect.

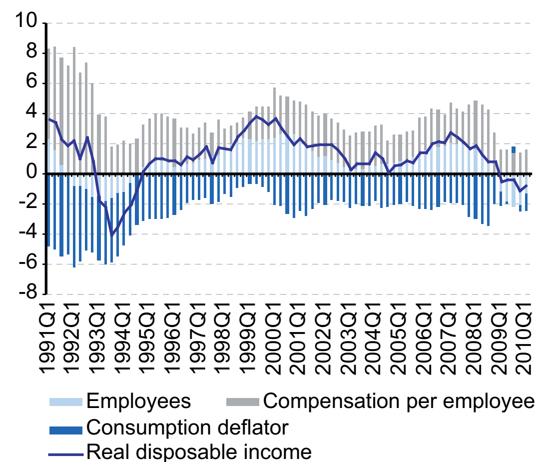
Across large countries, the weakness of private consumption is widespread, especially seen in the strong drop in private consumption in Germany in the first quarter, while retail sales remain very subdued in April and May (leaving the average of both months only 0.1% above Q1). In France, households' consumption also dropped in June, remaining also below the level recorded in Q1 (-0.9% q/q). Taking into account all data, we expect private consumption to remain flat in the eurozone as a whole in Q2.

Chart 5
Eurozone: Households' consumption



Source: Eurostat and BBVA Research

Chart 6
Eurozone: Households' disposable income



Source: ECB and BBVA Research

Public consumption is being affected by fiscal restraint measures

Public consumption increased substantially since mid-2008 as national governments implemented fiscal stimulus. However, government spending started to decline since the last quarter of 2009, as expansionary fiscal measures ended and the mood changed towards the need to restraint deficits. In particular, public consumption in the eurozone declined by -0.2% q/q in Q4 2009 and increased by a modest 0.2% q/q in Q1, far from the average quarterly growth of around 0.8% the end of 2008. It is likely that public spending will continue to slow in coming quarters, especially as from next year when all countries will have to implement austerity measures to comply with the SGP. This will reduce considerably its contribution to GDP growth.

Industrial output has been strong recently but presents doubts for the coming future

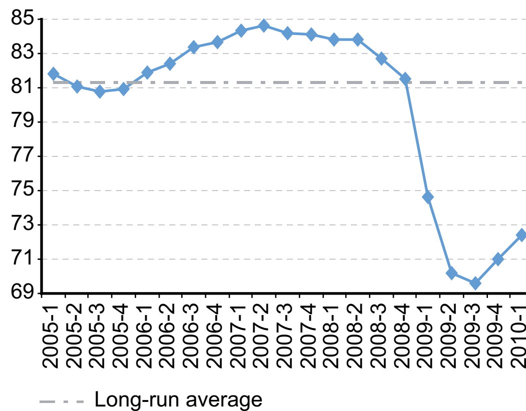
Positive data come from the strong recovery of the industrial sector: Output in April and May grew at around 2.5% over Q1, when it also recorded a high growth rate. In addition, industrial new orders grew strongly again in May, suggesting that the industrial upturn could continue in coming months. Across large countries, industrial output has increased at different speeds, more markedly in Germany, while its growth was more moderate in France and Italy and was negative in Spain and Portugal. The strong industrial sector recovery reflects mostly export growth, sustained in turn by the robust global upturn and the euro depreciation. For the coming months, the outlook on industrial production is uncertain. While the most recent confidence indicators have been strong in July in the industrial sector, orders from abroad have slowed in recent months, and the outlook at the global level is moderating rapidly. Without a clear recovery of domestic demand, which we do not foresee, the current strength of industrial production is likely to moderate in coming months.

Investment has been falling as capacity utilization is low, while inventories build-up is unlikely to add much more to output

Up to the first quarter of this year, investment has fallen by around 1% q/q on average each quarter since Q3 2009, and although the deteriorating pace slowed with respect that observed in late 2008, it shows the weakness of the economic recovery and might have possible adverse effects on potential growth in the medium term. With industrial output continuing to grow, but a more moderate pace, and with capacity utilisation still at low levels, companies can cope with the increase in production without the need to invest further, as both shown by the low investment rate and the fall in credit to non-financial corporations (around 2.5% over the last year).

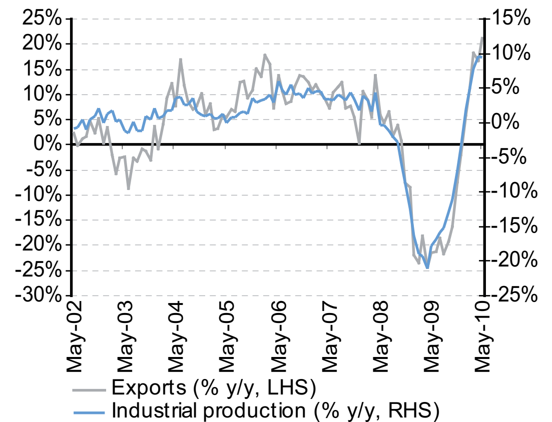
As for inventories, they fell drastically during the recession. After that, with the global economic recovery and increasing orders, companies embarked in an intense process of rebuilding stocks, contributing significantly to GDP growth and partially offsetting the strong decline in domestic demand. However, this process is temporary, and recent data show that the stock of finished products, taking into account new orders, is reaching levels similar to those observed before the crisis, exhausting its positive effect on the economy.

Chart 7
Eurozone: Capacity of ulitization



Source: Eurostat and BBVA Research

Chart 8
Eurozone: Industrial production and exports



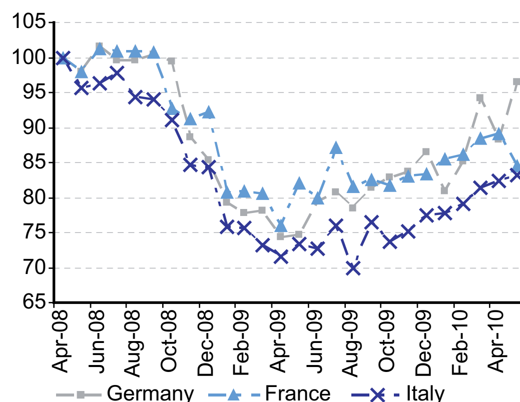
Source: Eurostat

Exports have become the main driver of the recovery in Q2, which should result in GDP growing by 0.4% q/q

According to monthly data for trade balance, nominal exports growth in April and May slowed but remained clearly positive, reaching a level which is 4% over the average of Q1 (when they grew at 7.1% q/q over the previous quarter). In addition, the volume of exports has continued to increase as well, staying now above the levels recorded in the last quarter of 2009 and recovering about 85% of the drop during the recession. However, the cumulative growth of imports in these two months of the second quarter was even higher (6.3%), and should partly offset the contribution of net exports to economic growth. As a result, we see a similar pattern of the external sector in Q1, i.e. a negative contribution on net exports of -0.6 percent points. The strong growth in imports in Q1 and in the first two months of Q2 is difficult to explain given the weakness of domestic demand, and we attribute it to the need of inputs required by the strong recovering industrial sector, which on the demand side go to exports and rebuilding inventories.

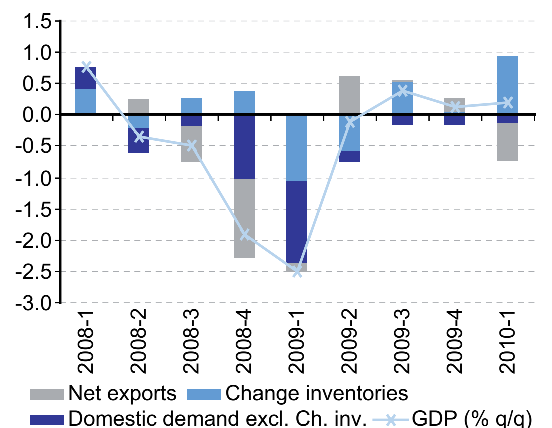
All in all, and despite some uncertainty surrounding the evolution of GDP components, our synthetic activity indicator suggests that GDP will grow by 0.4%-0.5% q/q in Q2.

Chart 9
Eurozone: Exports



Source: Eurostat

Chart 10
Eurozone: Contribution to quarterly GDP growth



Source: ECB and BBVA Research

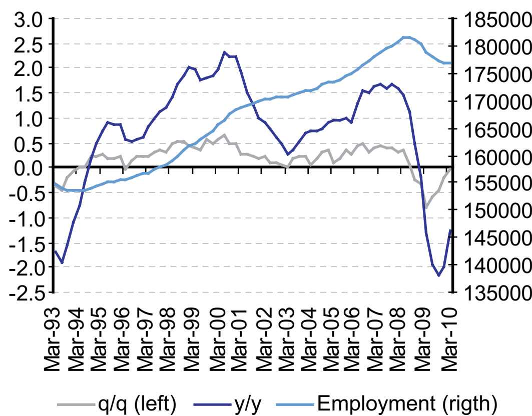
Labour market deterioration levelled off in Q2, while hiring intentions improved

Following the recovery of the eurozone economy, the deterioration of the labour market has diminished, although with de characteristic lag and very slowly as growth has not been enough to create new jobs. In particular, employment was flat in Q1, after falling for six consecutive quarters (accumulating a fall of around 2.5%). The sharp decline of the employment experienced since mid-2008 slowed in the last quarter of 2009 and unemployment has remained virtually stable at around 10% in the first half of the year.

Across countries, the divergence over the past quarters has been significant, with falling unemployment in Germany on the one side thanks to the short-time work scheme and to the recovery of industrial production (the rate stands at 7.6%) and very high rates in Ireland and mostly in Spain on the other (13.3% and 20%, respectively). In France and Italy unemployment has been stable in recent months, it stands at 10% and 8.5%, respectively).

Chart 11

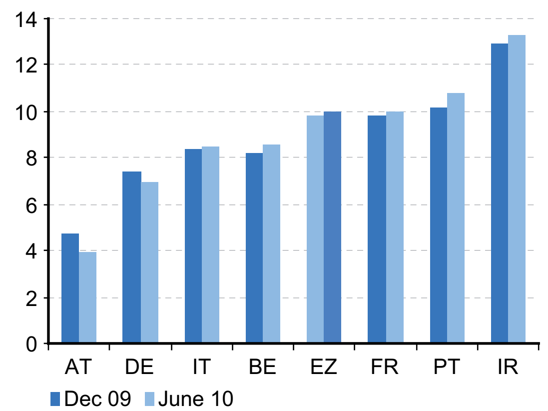
Eurozone: Employment



Source: Eurostat

Chart 12

Eurozone: Unemployment rate



Source: ECB and BBVA Research

Our medium term scenario is of a slowdown in the next two quarters and a mild recovery in 2011

Our projection of GDP growth for the eurozone is of around 1% for both 2010 and 2011. However, these broad numbers hide disparities, both in the performance of the economy in the two halves of 2010 and across countries. The base effect from the first half of 2010 is relatively high: although the figure for the first quarter was weak (0.1% q/q), our 0.4% projection for the second quarter is about the growth potential of the eurozone economy, and if anything the risks of the second quarter are tilted to the upside. For the second half of the year we expect a slowdown as the effect from the sovereign crisis starts to bite and the global slowdown moderates exports. Growth should be barely positive in this period. Once the financial situation is normalizes somewhat after the summer, growth could recover during next year, but moderately due to the compensating effects from a low euro and fiscal retrenchment, and with still high uncertainties. Due to the different base effects for 2010 and 2011 (high for the first and low for the second), average growth should be similar in both years despite the better dynamics of 2011.

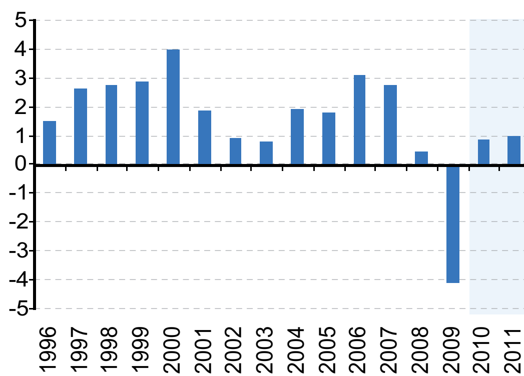
The same growth composition (tilted towards exports) will be accentuated by the low value of the euro and the fiscal adjustment

The trend of exports-based growth seen so far is likely to continue in the coming months. Fiscal austerity and financial stress will put a break to an eventual recovery of domestic demand, while the moderation of global growth will be compensated by the continued and delayed effects of the recent euro depreciation:

- Investment is likely to fall on average in 2010, due to the uncertainty surrounding the recovery, credit restrictions and especially the low use of capacity utilization. As long as the recovery sets in, and partly thanks to foreign demand, business confidence should strength further, risk aversion recover and investment plans increase, but this should be a slow process. Overall we expect a mildly positive growth rate for investment in 2011.
- With relatively weak growth and capacity utilization well below potential, employment is not expected to grow in 2011, which will affect the recovery of confidence household disposable income. This will restrain private consumption, together tax hikes in several eurozone countries. On average, consumption is expected to be flat this year and grow by about half a percentage point in 2011.
- Public consumption will moderate substantially due to fiscal austerity programs, mostly in 2011. From a growth rate of 2.7% in 2009 it is expected to slow down to 0.5% in 2011.

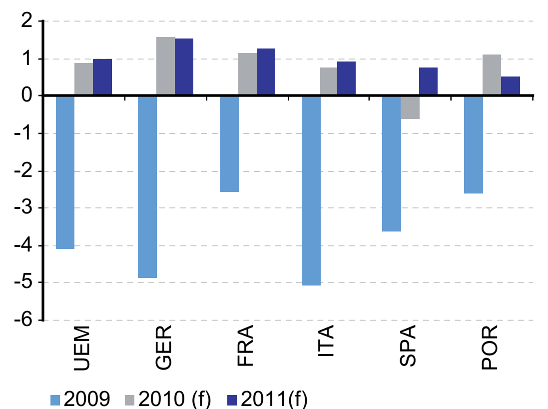
- Exports are expected to decelerate somewhat in the second half of 2010, with counteracting effects from a low euro and slowing global demand, but still be robust and grow on average at close to 8% for the whole year, and broadly the same rate in 2011. Imports are projected to follow through, with rates close to 7% per year, below that of exports as sluggish domestic demand pulls them back somewhat. As a result, net foreign demand will add 0.4 points to growth in 2010 and 0.6 points in 2011, above the historical average.

Chart 13
Eurozone: GDP Growth



Source: Eurostat

Chart 14
Eurozone: GDP Growth by countries



Source: ECB and BBVA Research

Across countries, Germany will continue to be above the average, while South European countries will perform worse

- **Germany** is the country which is leading industrial pickup thanks to its export strength to emerging economies. GDP growth is expected to be above the average in both 2010 and 2011, with a very sharp contribution of net exports this year and still strong next year. However, private consumption has fallen markedly in the first quarter, and indicators of retail sales for the second quarter have also been negative despite the good records of unemployment. Consumption is likely to recover, but only moderately, and could grow by around 0.5% in 2011.

- **France** had a weak first quarter and consumption indicators for the second are not very positive either. It is expected to grow slightly above the Eurozone, with a larger contribution of domestic demand than Germany, especially due to more resilient private consumption. As in Germany, there are still some measures of fiscal stimulus approved in 2009 that are having a positive effect in 2010. The contribution of the external sector likely to be slightly positive.

- **Italy** enjoyed relatively high growth in the first quarter (0.5%), but this was due to temporary factors such as strong stocks contribution and a fall of imports, together with resilient consumption. For the coming quarters, it is expected to grow in line with the average Eurozone, but below France and Germany, due to its lower potential. As in the case of France, growth is likely to be more based on domestic demand and less of the foreign sector, which is still projected to be mildly positive.

- **The Spanish** economy showed its first positive growth rate in 1Q10 since the beginning of the crisis (0.1% q/q). Besides, most recent data suggest that, supported mainly by the Spanish exports strength, GDP growth remained positive in 2Q10 (between 0.1% q/q and 0.2% q/q). Nevertheless, the acceleration of the fiscal consolidation process, together with the uncertainty and volatility persistence in financial markets, are likely to have a negative -but transitory and small- impact on GDP growth during second half of this year. All in all we expect an average GDP growth of -0.6% for 2010 and 0.7% for 2011.

- **Portugal** enjoyed surprisingly fast growth in the first quarter of this year (1.1% q/q) due to the strength of all components of domestic demand and the contribution of inventories, together with a fall in imports that resulted in a contribution of net exports of 0.8 points. This anomalous pattern is unlikely to be sustainable in coming quarters, we expect a significant moderation of activity, with average GDP growth falling form 1.1% this year to 0.5% in 2011, with a deceleration already in the second half of this year. The program of fiscal austerity and the high levels of leverage of Portuguese households are likely to result in a clear slowdown of domestic demand.

4. Inflation and ECB rates

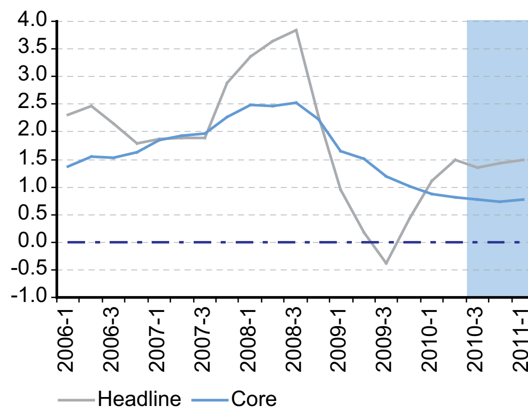
Headline inflation accelerated in Q2 driven by energy prices, while core inflation remained broadly stable

Inflation has surged in the second quarter of 2010 to 1.5% y/y from 1.3% y/y in the first, mainly due to the evolution of energy prices that have soared from 4.4% y/y observed in Q1 to 8.2% in Q2. The acceleration of energy prices can be attributed both to a base effect (the same months last year, prices fell sharply) and to the evolution of oil prices and the depreciation of the euro. In fact, the acceleration on the headline inflation (0.3pp) corresponds mainly to a similar increase in the contribution of energy prices (0.3pp). Core inflation has remained broadly stable since the beginning of the year at around 0.8-0.9% y/y, but after slowing in April and May (larger Easter effect), it has accelerated again in June to 0.9% a/a. This reacceleration has been an upwards surprise. Across its components, services prices have remained relatively stable in the first half of the year, while inflation has picked up slightly in both non-energy industrial goods and processed food. In July inflation has increased again to 1.7%, with a possible increase also in core prices. The July data reflect the sales effect coupled with VAT hikes in Spain.

Inflation is expected to remain well under ECB's target

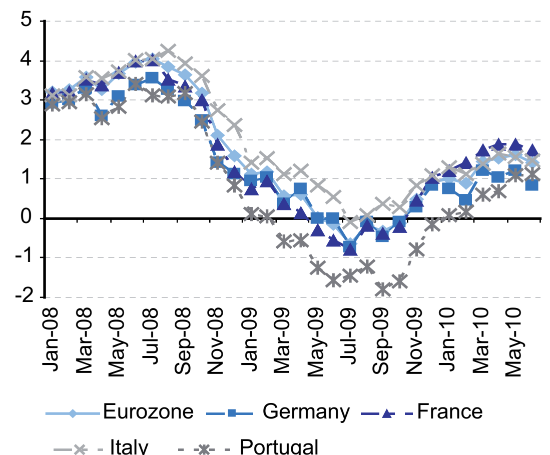
For the second half of the year, we expect inflation to remain relatively stable, reflecting the moderation of economic activity, which should offset the price increases due to higher taxes. Additionally, industrial inflation has returned to positive territory with significant annual rates, after a year registering negative figures. However, it is unlikely to end up moving to consumer prices, given the weakness of domestic demand. Regarding, core inflation, we expect it to remain stable around current levels or to slow slightly. The outlook for the coming year is of a moderate inflation, well below the ECB's target, without inflationary pressures given the weakness of the economic recovery. Finally, we see some downside risks to our projections to the extent that the slowdown in economic activity expected should pit downward pressures on consumer prices, although these downside risks could be offset by a higher impact of the VAT hike.

Chart 15
Inflation



Source: Eurostat

Chart 16
By countries



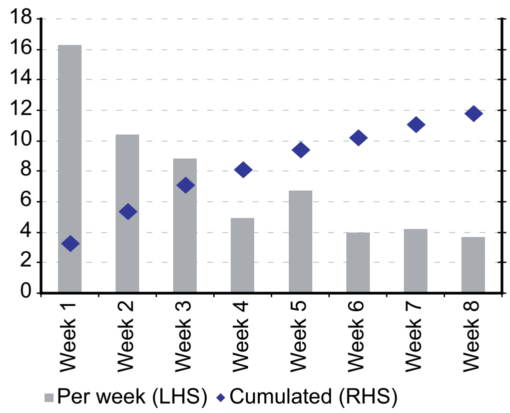
Source: ECB and BBVA Research

The ECB has not been very active buying bonds, but we expect now it to remain on hold until at least the end of 2011

As explained in the previous issue of this publication, the ECB reacted to the sovereign crisis in various ways, including a relaxation of collateral rules for Greek debt in March, three further long-term liquidity auctions with full allotment and the purchase of public and private debt in secondary markets, in order to relax tensions in financial markets (Securities Markets Programme, SMP). During the only press conference by Mr Trichet after an ECB meeting since our last publication, the stance of monetary policy was barely addressed, and the statement of the Council did not include any major changes (most of the press conference was devoted to the issue of stress tests and the sovereign crisis).

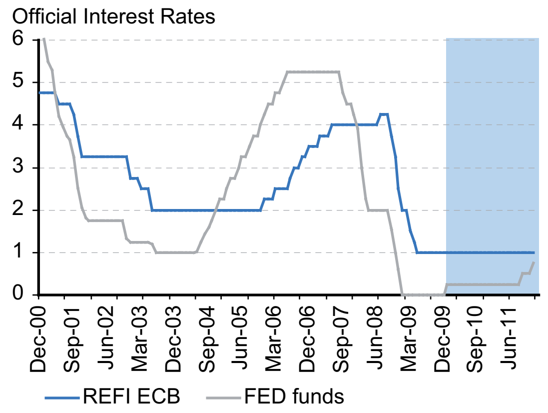
The activation of the SMP have been diminishing since its start (see Chart), and in recent weeks the amount of bonds bought by the national institutions has been very low. Although this raises doubts on the willingness of the ECB to expand further to mitigate liquidity tensions in debt markets, we foresee that it will remain committed to do whatever is necessary to sustain activity and to reduce liquidity tensions in financial institutions, maintaining extraordinary liquidity measures (full allotment in weekly auctions) for as long as it is necessary. Given the very inflation outlook and the projected softness of activity, we have revised our projection for official repo rates and now foresee that they will remain at 1% for the foreseeable future, and at least until the end of 2011.

Chart 17
ECB Sovereign debt purchase program



Source: Eurostat

Chart 18
Eurozone: Official Interest Rates



Source: ECB and BBVA Research

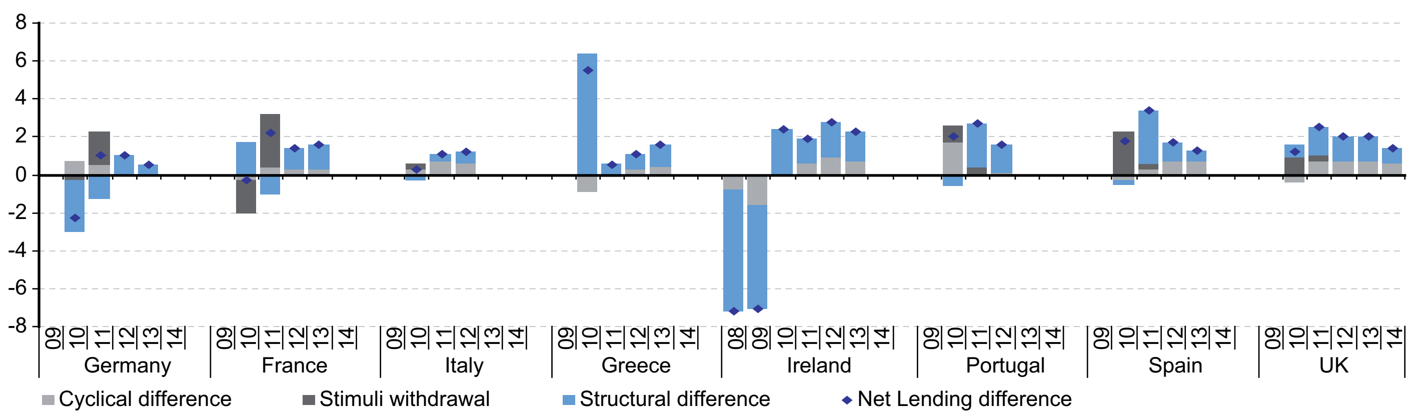
5. Fiscal monitor: the effects of fiscal tightening

The fiscal situation has deteriorated rapidly in many EU countries, but not only due to the stimulus

Fiscal stimulus programmes approved at the end of 2008 and implemented during the last year and an half implied, on their own, an increase in public deficits which was manageable in principle: the size of the stimulus in all European countries was below 2% of GDP and the cyclical deterioration of public accounts has not added in general more than 2 percentage points of GDP to the deficit. However, there has been an additional deterioration of structural deficits, mostly due to the permanent loss of revenues derived, among other things, from the burst of asset price bubbles. This has translated into very high deficits in several southern European economies, Ireland and the United Kingdom. In the context of such unprecedented deficits in peacetime, fears of an uncontrollable situation on the fiscal front have come to the fore, increasing sovereign credit risk and undermining confidence on the financial health of institutions suspected of holding sizable amounts of sovereign assets. This has led many of these countries to design and implement fiscal consolidation plans before the recovery is complete in order to restore market confidence.

Chart 19

Europe: size and composition of consolidation: year on year difference



Source: BBVA Research and EC

Consolidation plans in Europe are being implemented according to schedules presented to the EC at the beginning of 2010

These consolidation plans had already been presented to the European Commission in late 2009. The aim was to bring deficits down below 3% by 2013 or 2014, but postponing the bulk of the adjustment until after the end of 2010. Since the outset of the sovereign crisis, two of the countries most affected by the lack of confidence from markets (Spain and Portugal) have announced additional measures to bring the adjustment forward, whereas the United Kingdom has presented a whole new programme after the May elections that also results in a faster adjustment –something which was badly needed, given that previous plans presented to Brussels failed to include a target below 3% even by 2014. In the case of Greece, consolidation efforts have been actually spread out over a longer horizon in the context of the IMF/EC/ECB program, making them more credible than the excessively tight adjustment projected in the original plan presented by the Greek government. For other countries, despite the flurry of news in recent months on fiscal consolidation, deficit-reduction paths are unchanged, and instead some details have been announced on what exactly will be done, especially for the 2011 budget. The fact remains that for the largest Eurozone economies the adjustment will only start in 2011, whereas for those countries with weaker starting points deficit cut measures have already started to bite.

The fact that a sizable share of the increase in fiscal deficits can be attributed to an increase in the structural deficit calls for consolidation plans that focus on the structural side. And that is, in fact, what plans presented to the EC envision (see Chart 19). Nevertheless, as we stress above, most consolidation plans still lack crucial details about how that structural adjustment is to be made, especially after 2011, which risks undermining the credibility of the exercise.

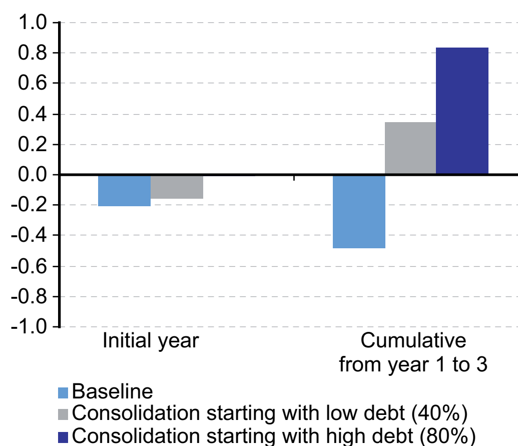
Well designed austerity plans can limit their effect of activity

Fiscal consolidation will end up having a limited impact on economic growth if it is accompanied by the right policies and if the uncertainties currently besetting international financial markets recede significantly. Specifically, empirical evidence usually shows that, after decisive fiscal consolidation some countries actually experienced economic growth, as rising private demand more than compensate the fall in public consumption. This positive wealth effect and resurgent confidence tend to be higher when the process of fiscal consolidation (i) is perceived as a "change in regime", that is, when it is accompanied by a string of structural reforms designed to enhance economic growth and thus fiscal sustainability; (ii) relies heavily on reducing public expenditure, more than increasing revenues (and thus the distortions associated with increased taxation); (iii) is sizable and perceived as permanent, thus increasing credibility, for example focusing on spending cuts, including legislation that creates binding multi-year targets and strengthening fiscal institutions, and (iv) is implemented in an economy that has reached extreme levels of macroeconomic instability, for example due to increasing levels of public debt or balance-of-payments difficulties.

Contrary to the conventional wisdom, our calculations show that the short- and long-run effects of deficit-reduction programs on economic activity are small, and in line with some previous contributions to this literature, for example, Alesina, 2010)[1]. To obtain this result, we have built a dynamic panel data model to measure the impact of fiscal tightening on economic performance[2]. The result of a basic specification shows that a fiscal impulse (tightening) raises (depresses) output, but to a limited extent, a fiscal tightening of 1% of GDP lowers output contemporaneously by around 0.13% (see Charts 20 and 21). Chart 20 also shows that the drag on growth of a reduction in the cyclically adjusted primary deficit is tempered (and can even be reversed in the long run) when such reduction is done in the context of a consolidation program (defined as a reduction of the deficit of at least 1% of GDP)[3]. We also explore the role of the starting debt level as consolidation processes have less negative effects on growth in highly-indebted economies. The short-run negative effects are a bit lower in low-indebted countries and a bit higher in highly-indebted ones. Our dataset allows also distinguishing between spending and revenue-based consolidations, so we analyze the fiscal balances developments by breaking it up into primary expenditure and revenue (both cyclically adjusted), in order to capture the differential effects of expenditure-based consolidations. Econometric evidence also supports the evidence that spending-based consolidations are more favourable to growth.

Chart 20

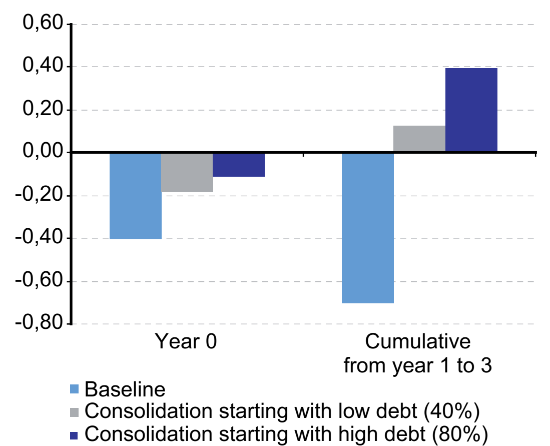
Response of GDP growth to an increase of CA primary surplus of 1% of GDP



* Coefficients from a panel regression of 15 European countries from 1970-2010, including 63 consolidation episodes, defined as years where the cyclically adjusted primary deficit was reduced by at least 1% of GDP
Source: BBVA Research

Chart 21

Response of GDP growth to discretionary reduction in expenditure of 1pp of GDP



Source: BBVA Research

1: Alesina (2010), "Fiscal adjustments: lessons from recent history", prepared for the Ecofin meeting in Madrid April 15 2010.
2: The baseline version of the model includes the following variables, the dependent variable is real GDP growth while the explanatory variables: Lagged dependent variables are World GDP growth, public debt (%GDP), "regression-based" fiscal impulse/tightening measure, real effective exchange rates and the real long-term interest rates: 10-year bond rate. The fiscal tightening measure was constructed following these steps: (1) Run country regressions of Fiscal Revenue (%GDP) on GDP growth, time trend and constant (2) Run country regressions of Fiscal Expenditure (%GDP) on GDP growth, time trend and constant (3) Obtain the series of estimated residuals of both regressions for each country. (4) Obtain the first differences of these estimated residuals (proxy of innovation) and (5) Subtract these first differences of revenue and expenditure, obtaining impulse/tightening measure expressed in terms of fiscal surplus (%GDP).
3: The consolidation dummy takes on value 1 when there is such consolidation episode in the sample and 0 otherwise.

Furthermore, the beneficial effects of a fiscal consolidation are stronger when started from a high level of public debt, in line with the discussion above. The particular cases of fiscal reform in Ireland (1985-1989), Denmark (1983-1986) and Spain (1993-1999) are good examples of how a credible fiscal adjustment accompanied by an improvement in the macroeconomic environment can ensure that increased private consumption, investment –both resulting from improved expectations– and net exports more than offset declining public expenditure and, therefore, have a growth-generating impact even in the short term.

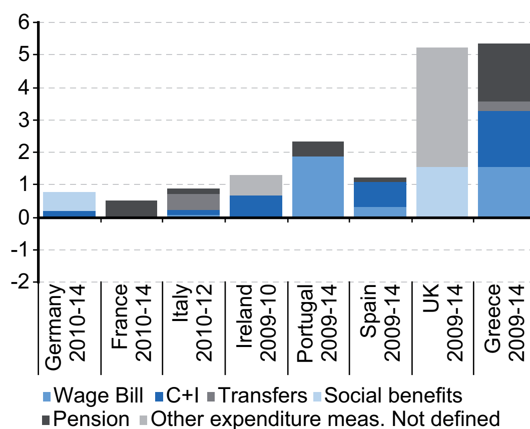
In the current EU context, some countries are applying accompanying structural reforms, most notably on pensions

On the first condition cited above for a successful fiscal consolidation (a change in regime with structural reforms), several countries are approving structural reforms, notably Greece and to a lesser extent Spain. In the case of Greece, reforms on labour, taxes and competition are to a large extent determined by the need to make spending cuts and obtain higher revenues (and in that sense they are not "accompanying" deficit measures but at the heart of them); they are also partly imposed by the international institutions that survey the aid package. In Spain a financial reform has been approved to restructure savings banks and a labour reform is under way, in the process of being approved by the Parliament. Several countries have approved (Greece), are in the process of approving (France) or have announced (Spain) pension's reforms, which are probably not likely to reduce spending much in the short run, but will result in savings in the medium to long run and thus increase confidence on the long-term sustainability of their finances.

The planned adjustment is fast and tilted towards reducing expenditure, which will boost confidence

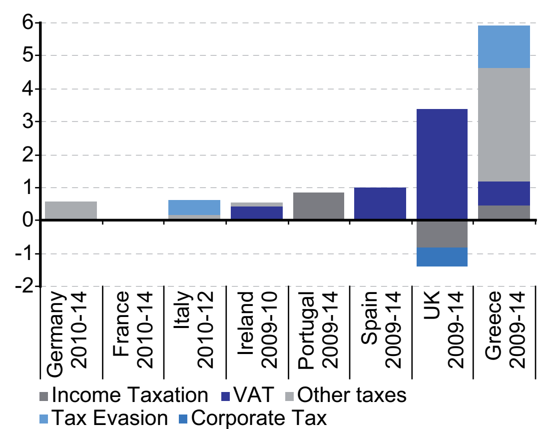
On the second condition for a successful fiscal austerity plan, it is important to highlight that plans approved so far in Europe, although lacking detail (especially for 2012 and beyond) are mostly based on spending cuts, notably in Germany, Italy and Ireland (see Charts 22 and 23). In other countries, partly because of the large effort needed, tax measures have been also approved or planned, as in Portugal, Spain or especially Greece. France has a mixture of both, while the United Kingdom has approved higher taxes for 2011 and left a large share of the more difficult to implement spending cuts for 2012 and beyond. In all cases, it must be borne in mind that fiscal plans after 2011 are only intentional, and most of them have to be spelled out and approved, which implies that they could be subject to substantial changes in coming years.

Chart 22
All detailed expenditure measures as % of GDP



Source: BBVA Research

Chart 23
All detailed revenue measures as % of GDP



Source: BBVA Research

Deficit cuts in Europe are likely to have a mild effect on growth

All in all, the fact that in most countries the adjustment will be fast and sizable (see Chart 19), tilted more towards lower spending than higher taxes (Chart 21 and 22) and –in some countries– is accompanied by structural reforms shows clearly that policy makers have internalized the lessons from the past. These features increase the plans' chances of success and minimises their long-term impact on economic growth. Thus we expect the effect of fiscal consolidation in Europe to be limited and transitory, much lower than usually assumed.

Tables

Summary of forecasts

Table 1

Euro Area (YoY)

	2007	2008	2009	2010	2011
GDP at constant prices	**2.8**	**0.4**	**-4.1**	**0.9**	**1.0**
Private consumption	1.6	0.3	-1.2	0.0	0.4
Public consumption	2.3	2.2	2.7	1.0	0.5
Gross Fixed Capital Formation	4.6	-0.9	-10.9	-3.4	0.3
Inventories (*)	0.0	0.1	-0.8	1.0	0.0
Domestic Demand (*)	**2.4**	**0.5**	**-3.3**	**0.5**	**0.4**
Exports (goods and services)	6.3	0.7	-13.2	7.7	7.9
Imports (goods and services)	5.5	0.8	-11.9	6.9	6.7
External Demand (*)	**0.4**	**0.0**	**-0.8**	**0.4**	**0.6**
Prices and Costs					
CPI	2.1	3.3	0.3	1.3	1.2
CPI Core	2.0	2.4	1.3	0.8	0.8
Labour Market					
Employment	2.0	0.9	-1.8	-0.6	0.0
Unemployment rate (% of labour force)	7.5	7.6	9.4	10.1	10.5
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-0.6	-2.0	-6.3	-6.8	-5.5
External Sector					
Current Account Balance (% GDP)	0.4	-0.9	-0.6	-0.5	-0.2

* Contribution to growth
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.1	0.4	-2.4	3.0	2.5
UK	2.6	0.5	-4.9	1.4	1.7
Latin America *	5.8	4.0	-2.4	5.2	4.2
Asia	7.6	4.2	2.0	6.4	5.5
China	14.2	9.6	9.1	9.8	9.2
Asia (exc. China)	5.2	2.2	-0.7	5.1	4.1
World	5.3	3.0	-0.6	4.4	4.1

Forecast closing date: 31st July 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.9	3.8	-0.4	1.6	1.8
Latin America *	6.0	9.0	7.4	8.1	8.4
Asia	2.8	4.9	0.3	2.9	2.8
China	4.8	5.9	-0.7	2.9	3.3
Asia (exc. China)	2.1	4.6	0.6	2.8	2.6
World	4.1	6.1	2.0	3.5	3.3

Forecast closing date: 31st July 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 4

Financial variables

Official Interest Rates (End period)	2007	2008	2009	2010	2011
United States	4.3	0.6	0.3	0.1	0.8
EMU	4.0	2.5	1.0	1.0	1.0
China	7.5	5.3	5.3	5.6	6.1
10-year Interest Rates (Avg).					
United States	4.6	3.6	3.2	3.4	3.7
EMU	4.2	4.0	3.3	2.8	3.0
Exchange Rates (US Dollar per national currency)					
United States (EUR per USD)	0.7	0.7	0.7	0.8	0.8
EMU	1.4	1.5	1.4	1.3	1.2
UK	2.0	1.8	1.6	1.5	1.4
China	7.6	6.9	6.8	6.7	6.4

Forecast closing date: 31st July 2010
Source: BBVA Research

Germany

Table 5
GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	-0.3	0.2	0.0	-0.8	0.6
Public consumption	1.7	2.0	3.4	1.4	0.9
Gross Fixed Capital Formation	5.3	2.3	-8.9	1.5	2.8
Inventories (*)	-0.2	0.5	-0.5	0.3	0.0
Domestic Demand (*)	**1.0**	**1.5**	**-1.7**	**0.5**	**1.1**
Export	7.8	2.4	-14.5	6.9	6.0
Import	5.0	3.9	-9.5	4.9	5.6
Net export (*)	**1.6**	**-0.5**	**-3.2**	**1.1**	**0.5**
GDP	**2.6**	**1.0**	**-4.9**	**1.6**	**1.5**
Inflation	**2.3**	**2.8**	**0.2**	**0.9**	**1.1**

(*) Contribution to growth
Source: BBVA Research

France

Table 6
GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	2.5	0.5	0.6	0.9	1.1
Public consumption	1.5	1.6	2.7	1.5	0.4
Gross Fixed Capital Formation	5.9	0.3	-7.0	-2.0	2.3
Inventories (*)	0.0	0.3	-1.9	0.5	0.1
Domestic Demand (*)	**3.4**	**0.4**	**-2.4**	**0.9**	**1.2**
Export	2.5	-0.8	-12.2	5.5	5.6
Import	5.7	0.3	-10.6	4.1	5.0
Net export (*)	**-1.0**	**-0.3**	**-0.2**	**0.2**	**0.0**
GDP	**2.3**	**0.1**	**-2.5**	**1.2**	**1.3**
Inflation	**1.6**	**3.2**	**0.1**	**1.6**	**1.4**

(*) Contribution to growth
Source: BBVA Research

Italy

Table 7
GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	1.1	-0.8	-1.8	0.7	0.8
Public consumption	0.9	0.8	0.6	0.2	0.2
Gross Fixed Capital Formation	1.3	-4.0	-12.2	-0.2	2.1
Inventories (*)	0.1	-0.3	-0.4	0.2	0.0
Domestic Demand (*)	**1.2**	**-1.4**	**-3.8**	**0.6**	**0.9**
Export	3.9	-3.9	-19.1	3.7	4.2
Import	3.3	-4.3	-14.6	3.1	3.8
Net export (*)	**0.2**	**0.1**	**-1.2**	**0.1**	**0.1**
GDP	**1.4**	**-1.3**	**-5.1**	**0.7**	**0.9**
Inflation	**2.0**	**3.5**	**0.8**	**1.5**	**1.6**

(*) Contribution to growth
Source: BBVA Research

Portugal

Table 8

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	2.5	1.8	-1.0	1.4	-0.1
Public consumption	0.5	0.6	3.0	-0.7	-1.2
Gross Fixed Capital Formation	2.6	-1.8	-11.9	-3.5	-1.5
Inventories (*)	-0.1	0.3	-0.6	0.0	0.0
Domestic Demand (*)	**2.2**	**1.2**	**-3.3**	**0.1**	**-0.6**
Export	7.6	-0.3	-11.8	5.4	5.1
Import	5.5	2.8	-10.8	1.6	1.3
Net export (*)	**0.2**	**-1.2**	**0.7**	**1.0**	**1.1**
GDP	**2.4**	**0.0**	**-2.6**	**1.1**	**0.5**
Inflation	**2.0**	**3.5**	**0.8**	**1.5**	**1.6**

(*) Contribution to growth
Source: BBVA Research

Spain

Table 9

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	3.6	-0.6	-5.0	-0.3	0.3
Public consumption	5.5	5.5	3.9	1.4	0.2
Gross Fixed Capital Formation	4.6	-4.4	-15.2	-9.5	-3.2
Equipment and other products	6.8	-2.7	-20.6	-9.4	-1.9
Construction	3.2	-5.5	-11.1	-9.5	-4.0
Housing	3.0	-10.3	-24.5	-16.8	-6.1
Other construction	3.3	-0.4	1.6	-4.3	-2.5
Inventories (*)	-0.1	0.1	0.0	0.0	0.0
Domestic Demand (*)	**4.4**	**-0.5**	**-6.4**	**-2.2**	**-0.6**
Export	6.6	-1.0	-11.3	6.6	7.3
Import	8.0	-4.9	-17.7	0.0	1.5
Net export (*)	**-0.9**	**1.4**	**2.8**	**1.5**	**1.3**
GDP	**3.6**	**0.9**	**-3.6**	**-0.6**	**0.7**
Inflation	**2.8**	**4.1**	**-0.3**	**1.6**	**1.4**

(*) Contribution to growth
Source: BBVA Research

United Kingdom

Table 10

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	2.2	0.4	-3.3	0.4	1.3
Public consumption	1.3	1.8	1.0	1.6	-2.1
Gross Fixed Capital Formation	7.8	-5.0	-15.0	2.8	2.2
Inventories (*)	0.1	-0.5	-1.1	0.7	0.5
Domestic Demand (*)	**3.0**	**-0.3**	**-4.4**	**1.0**	**0.7**
Export	-2.6	1.0	-10.6	3.0	5.9
Import	-0.8	-1.2	-12.4	5.4	2.8
Net export (*)	**-0.5**	**0.7**	**0.8**	**-0.7**	**0.7**
GDP	**2.7**	**-0.1**	**-4.9**	**1.4**	**1.7**
Inflation	**2.3**	**3.6**	**2.2**	**3.0**	**2.5**

(*) Contribution to growth
Source: BBVA Research

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