BBVA | RESEARCH

Europe Economic Outlook

May 2011

Main messages

1. **Outlook:** Foreign demand, especially from emerging countries, is compensating for headwinds from oil prices, a higher euro and especially the crisis in the periphery.

2. **Divergence persists:** Growth in the periphery remains negative or subdued, as a consequence of strong fiscal adjustment and deleveraging of the private sector. Germany and the rest of core Europe are growing fast, but the recovery should broaden more decisively to domestic demand.

3. **Financial stress remains:** March summits have not addressed solvency concerns. A satisfactory solution of the Greek debt crisis by end June is key for reducing stress in the rest of the periphery.

Outline

1 Economic Outlook

[See index]

Section 1

Drivers of growth

Oil Brent prices

25% higher

- Small negative impact on GDP
- Temporary effect on inflation

Interest rates

ECB: +50bp in 2011 and +50bp in 2012

- Limited negative impact on GDP
- Negligible effect on inflation

External demand

- Euro more appreciated
- Strong foreign growth

Moderate effect on activity

Domestic Demand

- Stronger than expected
- Supported by labour market performance and confidence

Slight positive impact on GDP

Fiscal policy

Contractionary

- Additional fiscal retrenchment
- Limited impact on growth in core countries

Section 1

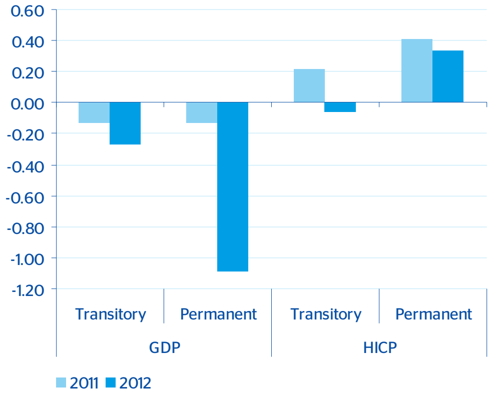
The effects of oil price hikes

The temporary increase in oil prices will have a moderate impact on activity

- The current price shock is more a demand shock due to precautionary motives than a pure supply shock
- Limited impact on growth: activity has not been affected, although an impact is expected to H2 2011 and next year
- The impact on inflation would be felt much more rapidly, although also limited

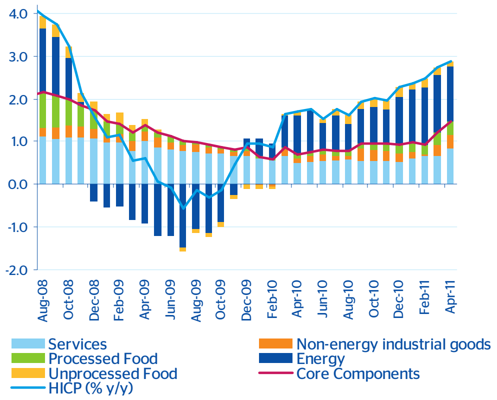
Oil shock impact in the eurozone (pp)

Source: BBVA Research from a estimated SVAR model with sign restrictions



Annual HICP inflation rate: Contribution by components (pp)

Source: Eurostat and BBVA Research

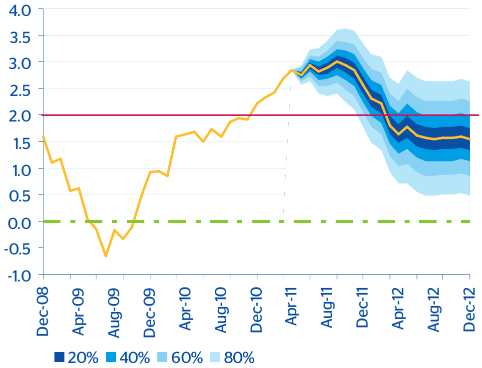


Section 1
Inflation

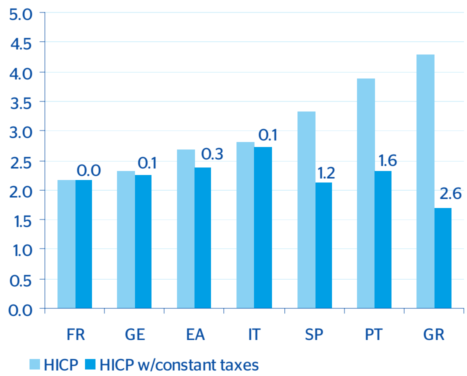
Inflation to revert to below the ECB's target in early 2012

- Inflation accelerated rapidly in Q1 due to the strong increase in commodity prices, while indirect effects were larger than expected. However, there are no signs of sizeable second round effects
- The acceleration shown in both headline and core inflation was widespread across member states, although in peripheral countries it was mainly a result of tax increases

HICP inflation (% y/y)
Source: Eurostat and BBVA Research



HICP inflation by countries (% y/y, values are differences in pp between rates)
Source: Eurostat

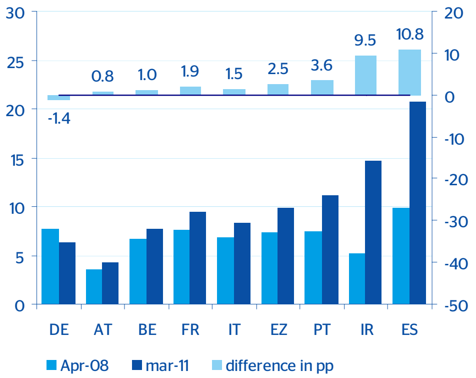


Section 1
Inflation

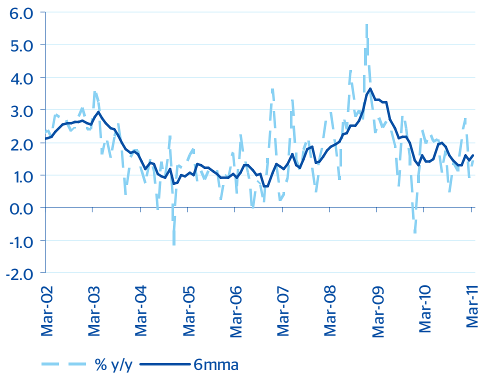
No evidence on second round effects

- Given domestic and labour market conditions in Germany, fears on second round effects are rising some concerns. But news of wage negotiations are not alarming on inflation pressures
- In most EZ countries, the prevalent high levels of unemployment (and the ongoing fiscal adjustment in the periphery) imply very low risks of second round effects to inflation

Unemployment rate
Source: Eurostat and BBVA Research



Germany: Wages and Salaries
Source: Bundesbank and BBVA Research



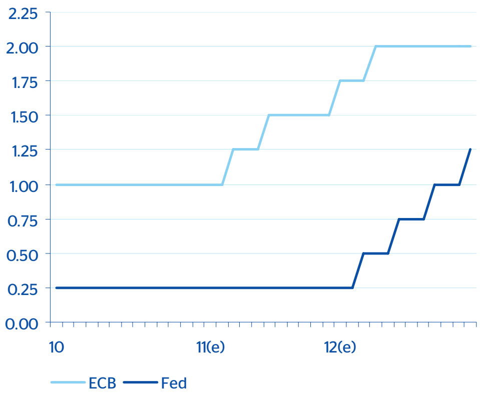
Section 1

Interest rates

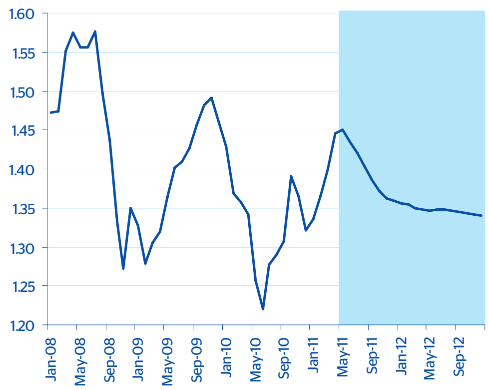
A slow rate hike cycle in the eurozone

- Pre-emptive interest rate hikes with limited impact on both activity and inflation
- Differences in monetary policy stance across economic areas are leading to a more appreciated euro that could also adversely affect foreign demand

Official interest rates
Source: ECB, Fed and BBVA Research



Euro exchange rate vs. dollar
Source: BBVA Research



Section 1

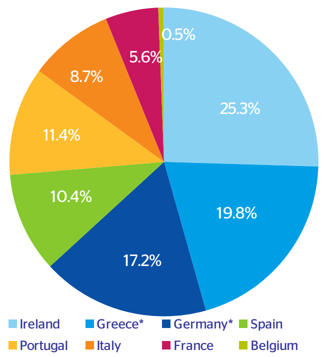
Monetary policy

ECB liquidity provision

- Although ECB funding has continued to decline this year it remains at high levels and continues to be concentrated in the most vulnerable banks. In the last few months some institutions have increased their demand
- Money markets have gone back to near normal levels, but this could be transitory because of the ongoing troubles in the eurozone. In this context, the ECB may be required to prolong its limit-free liquidity to the region's banks

ECB: use of MROs and LTRO (% of Eurosystem)

Source: Datastream, National Central Banks and BBVA Research



*April 2011= March data

Timing for phasing out full allotment

June ECB meeting	• **The ECB decided the extension of full allotment in all auctions (1w,1m,3m),** given sovereign stress • The last 3m auction is in September, ensuring liquidity until end year
September ECB meeting	• The decision will depend on market conditions at that time

Section 1

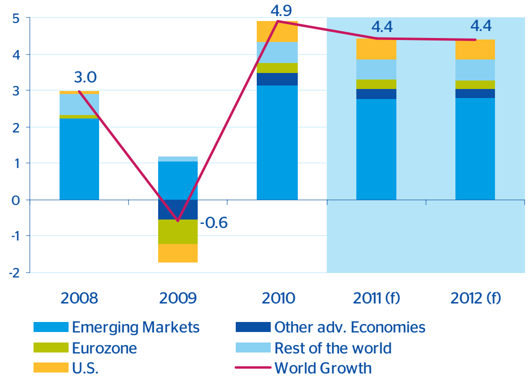
External sector

The EZ recovery continues to be supported by global demand

- Export dynamics continue to benefit from continued and robust external demand growth coming from emerging economies
- The external sector is increasingly relevant in the peripheral recovery (both extra and intra EZ trade). For these countries, net exports should be the main driver of growth

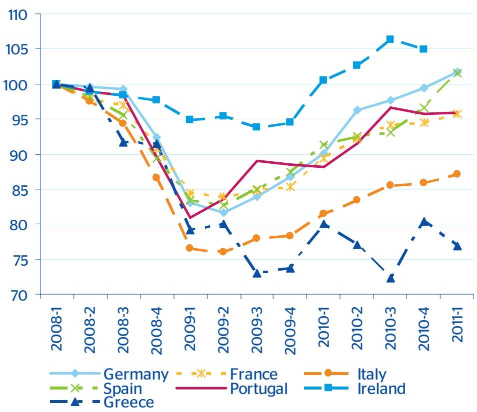
Global GDP growth and contributions (%)

Source: BBVA Research



Exports by country (Index, 1Q 2008=100)

Source: Eurostat and BBVA Research



Section 1

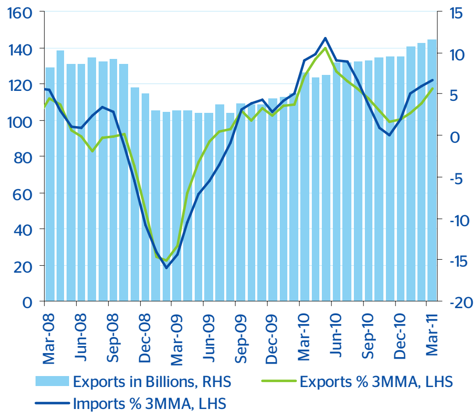
External sector

The EZ recovery continues to be supported by global demand

- Exports boosted investment, especially in equipment
- But the adjustment of construction sector, combined with public spending cuts, continue to put a break in the recovery of total investment

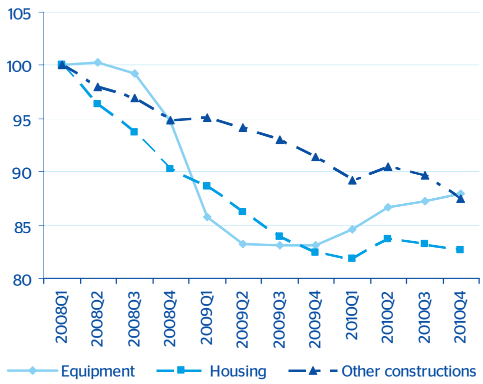
Eurozone: Exports and imports

Source: Eurostat and BBVA Research



Eurozone: Investment by components

Source: Eurostat and BBVA Research



Section 1

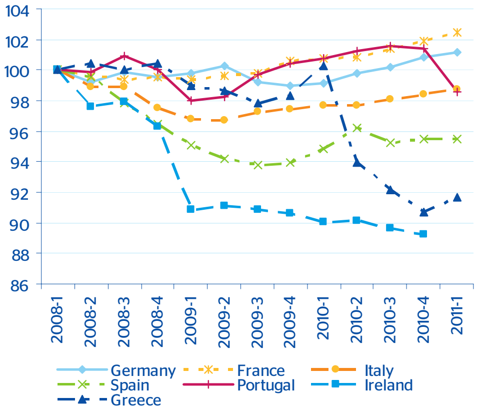
Domestic demand

Private consumption resilient, but without clear signs of a decisive recovery

- Households' disposable income has been undermined by the rise in inflation, and loose employment growth
- The divergence across member states is apparent, with consumption remaining very weak or contractionarv in the periphery, hampered by fiscal adjustment plans combined with the need to adjust private imbalances

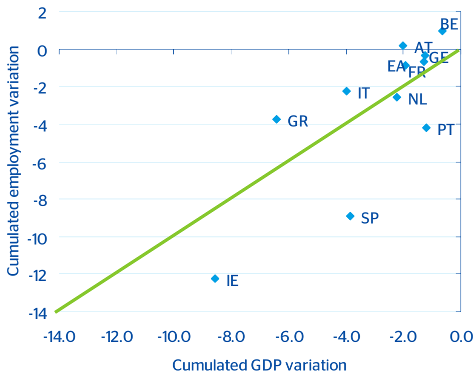
Private consumption by country

(Index, 1Q 2008=100)
Source: Eurostat and BBVA Research



Employment and activity

(Cumulated variation 2008-2010)
Source: BBVA Research



Section 1

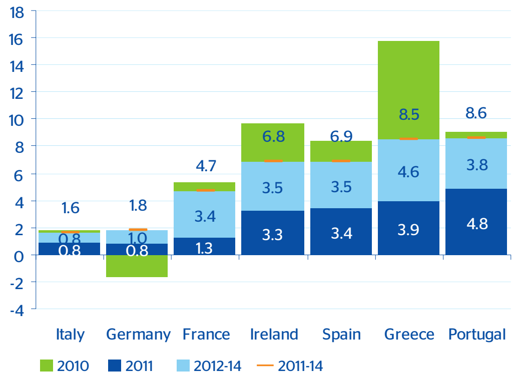
Fiscal policy

Fiscal consolidation is underway in all eurozone countries, but much stronger in the periphery

- In the periphery, Greece has done half of the required adjustment in 2010, but still has to make an adjustment of 8pp of GDP, together with Portugal
- Among core countries, Germany and Italy need to do relatively small structural adjustments, but that of France is large and still not very well defined

Structural adjustment effort (in pp of GDP)

Source: BBVA Research based on SGP's and own calculations



Section 1

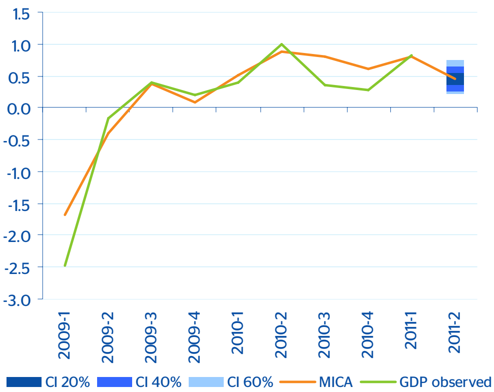
Macroeconomic scenario

Ongoing economic recovery at a moderate pace

- The strong acceleration observed in Q1 should have been temporary. We continue to see a slowdown in economic activity during the rest of 2011
- Across countries the picture will continue to differ in 2011 as a result of disparate performance of domestic demand. In 2012, divergence is expected to diminish

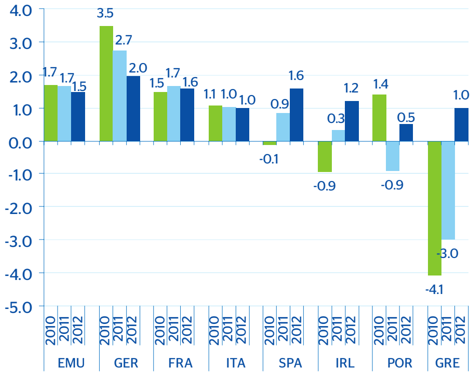
GDP growth and MICA model forecast (% q/q)

Source: Eurostat and BBVA Research



GDP growth by countries

Source: Eurostat and BBVA Research



2 Financial stress in the periphery

[See index]

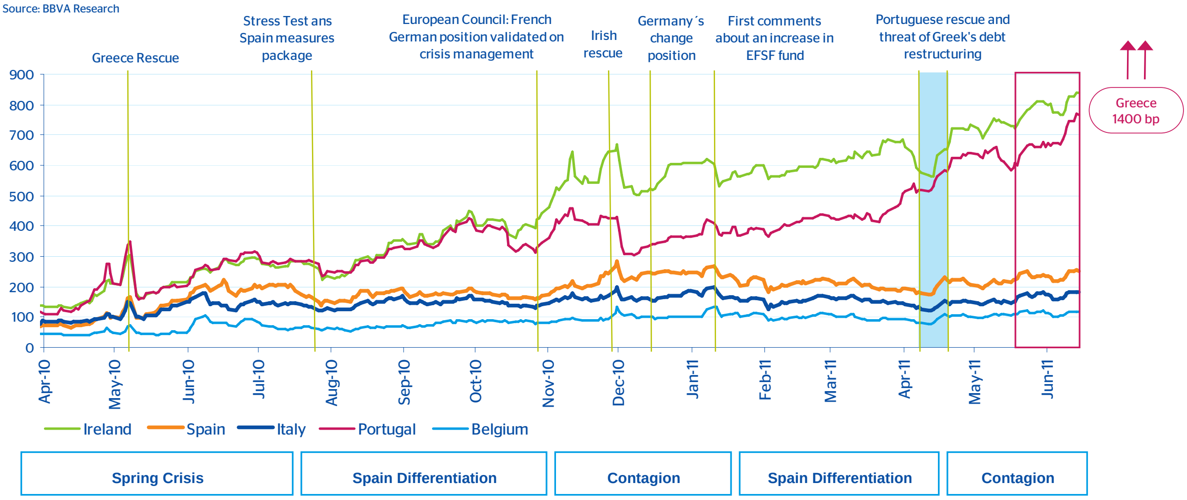
Section 2

Fears of a debt restructuring in Greece lead to the latest episode of contagion

Sovereing risks intensified again in the eurozone periphery countries, spilling over to more core-peripherals (Spain, Belgium and Italy)

10 yr spreads vs. Germany

Source: BBVA Research



Section 2

Financial stress remains

European summits have agreed on useful reforms (Pact Euro+, ESM approved) but not enough to end solvency concerns have not been addressed. European authorities continue to muddle through, in the face of restructuring fears on Greece

Elements of renewed European peripheral stress

- Weak European governments
- Solvency issues not directly addressed
- Risk of bail-ins prevent return to markets for Greece

→ Spreads likely to remain high for the foreseeable future

Section 2

Results of March reforms

March summits in Europe have brought several agreements that are helpful, but **solvency concerns for this crisis have not been addressed**

Pact for the euro (competitiveness)

Useful reforms for the long-run, not for solving this crisis, and not compulsory

- Fiscal rules, but not homogeneous and not in the constitution
- Wage setting reforms, but decided by each country
- Monitoring of pension sustainability, reforms country-specific
- Periodic stress tests to monitor financial stability

Crisis resolution and prevention

Only partial advances

- ESM will substitute EFSF as from mid-2013
- Increase EFSF/ESM thresholds
- EFSF/ESM able to buy bonds in primary markets, with strong conditionality
- Renegotiation of loan terms to Greece
- Bail-in system (CACs) as from 2013
- Include public and private imbalances in SGP

Section 2

Results of March reforms

March summits in Europe have brought several agreements that are helpful, but **solvency concerns for this crisis have not been addressed**

What's missing?

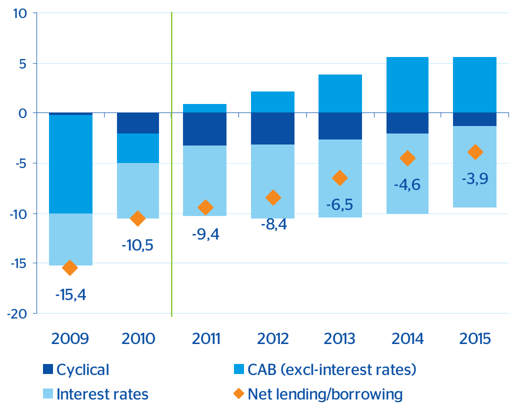
- Ideally, a eurobond-type solution should have been developed to solve the current crisis
- At the same time, the possibility of a bail-in system should have been introduced only gradually, for future crises, not from 2013
- EFSF/ESM being able to buy debt on secondary markets (not only in primary markets):
  - to take over from ECB role.
  - to make voluntary debt restructurings easier to implement.
- Sanctions for breaches of Stability and Growth Pact are not fully automatic

Section 2

What is the problem of Greece?

- **A large structural adjustment has been achieved in 2010,** despite missing the targets mostly due to continued upward revisions of historical debt
- **The Greek government has announced additional fiscal measures** in April to achieve targets

Greece, GG fiscal deficit
Source: Eurostat and BBVA Research



- Privatizations: EUR 15 Bln during the period 2011-13 and 50 Bln (around 20% of GDP) in total until 2015
- Additional fiscal consolidation effort of EUR 28.4 Bln 2011-15: 6.4 Bln for 2011 and 22 Bln during the period 2012-15. Consolidation measures are tilted towards the spending side, although there will be additional tax hikes and spending cuts in wages
- The focus of interest is now the fight against tax evasion, the main failure revealed so far

Section 2

What is the problem of Greece?

Despite this effort, Greece needs additonal funding

May 2010 | Aid programs IMF/EU | € 110 bn

Doubts about public accounts continue

May 2011

Has not fully met revenue plans

Financing given so far:
EUR 53 Bln

Trade deficit remains high

Reform fatigue

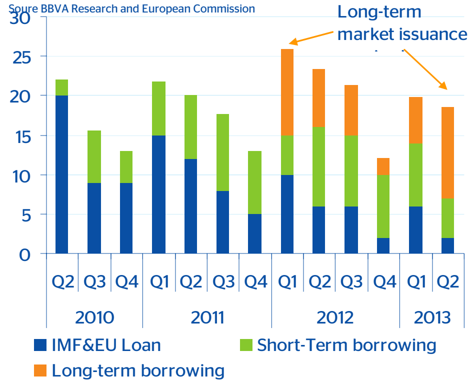
June 2011
Originally schedule disbursement:
EUR 12 Bln

IMF/EU/ECB have just completed a mission to Greece to assess progress before the next disbursement. Preliminary assessment is positive

- The first Greek rescue plan assumed access to markets in 1Q12
- This is now impossible given market conditions, and thus immediate action is needed to cover 2012 and after
- Financing needs between 2013-2015 are EUR 210 Bln

Greek sovereign financing sources

Soure BBVA Research and European Commission



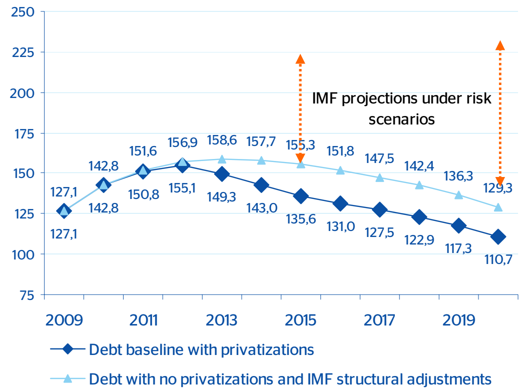
Section 2

Greek crisis: is the debt sustainable?

- The sustainability of Greek debt **depends on three crucial factors:** i) Implementation of a privatization program (could reduce debt by 20pp); ii) Tax revenues, dependent on combating tax fraud iii) Low interest rates

Greece: Public Debt

Source: BBVA Research



Two reasons to continue supporting Greece:

1. Europe wants Greece to commit to confronting structural reforms and privatization
2. To avoid further stress trough contagion in the rest of Europe that would arise if private sector involvement is not voluntary.

But many upside risks on the debt ratio: reform fatigue, lower growth, higher interest rates, support to banks, etc

Section 2

Greece: What is next?

End June	The troika (IMF+EC+ECB) approves the next tranche of its loan to Greece
30 June or after	Greek parliament approves the new fiscal consolidation plan + privatizations
11 July	Europe approves new financing to Greece until mid-2013, with a very minor involvement of the private sector (a voluntary rollover of debt which does not affect CDS markets)

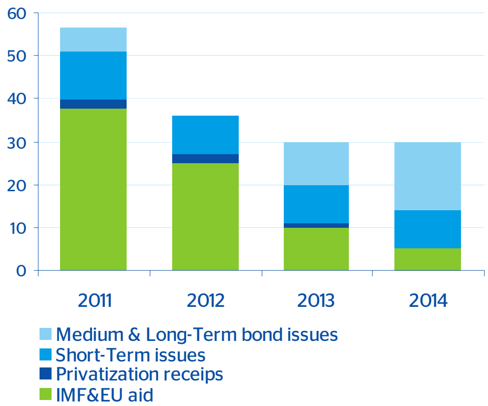
Section 2

Portugal: Good conditionality program

- The **emphasis of the rescue program (EUR 78 Bln, 7.5 years average maturity) is correctly put on structural reforms**, not fiscal adjustment, which is similar to the one already planned by the government)
- The **implementation risk is high.** But the new government has promised to go even beyond the plan, both on fiscal adjustment and privatizations

Portugal Financial Resoruces, € bn

Source: Eurosstat and BBVA Research



Economic and financial adjustment program

Fiscal side
- The plan targets a 3% deficit by 2013 instead of 2012
- Important tax reform: system less distortive and more pro-competitiveness
- Privatization program

Structural reforms
- It covers all the areas of weakness to boost potential growth (if fully implemented, potential growth could raise to 2%), create jobs, and improve competitiveness

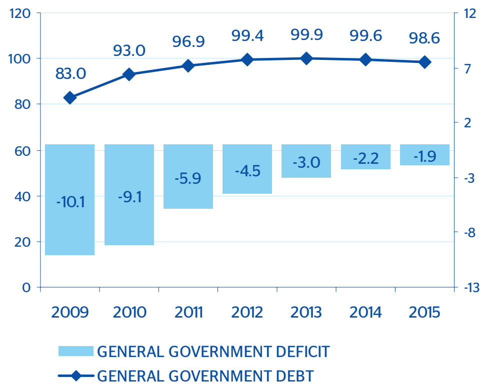
Financial sector
- It contains a banking support scheme of up to EUR 12 billion to provide the necessary capital in case market solutions cannot be found
- It addresses liquidity problems and increase solvency ratios (to 9% and 10% in 2011 and 2012)

Section 2

Portugal: Fiscal outlook

The rescue package came with milder conditionality in terms of fiscal targets

Portugal, buget deficit and debt (% GDP)
Source: Eurostat, IMF and BBVA Reaearch



- **Budget deficit revisions: from initial 7% to 9.1% in 2010**
- **Target for consolidation to reach 3% deficit delayed to 2013 and debt targets have been relaxed.** The IMF-EU plan is loaded versus structural reforms
- Passos Coelho, **the PSD leader, said that the agreements with the Troika will be respected and even he is willing to take further measures** (possibly through a more ambitious privatization program)
- In principle, **Portugal is far from restructuring public debt** (debt levels are below those of Greece, Ireland, Belgium and Italy)

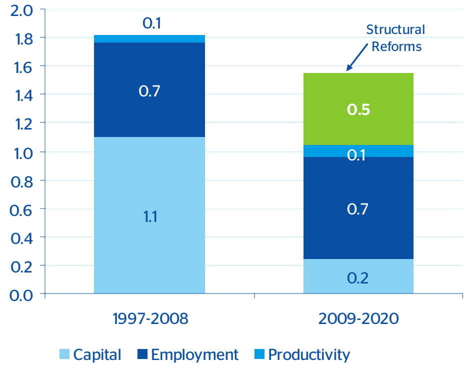
Section 2

Portugal: A problem of potential growth

The main focus of the conditions attached to the rescue plan is put to structural reforms, given the low growth capacity of Portugal

Portugal, Potential GDP growth

Source: BBVA Research



- **Reforms in the labor market and reduction of the weight of the public sector** through privatizations are likely to be at the centre-stage.
- **On the labour market,** they include lower dismissal costs, a single type of labour contract (to avoid labour market duality), decentralization of wage bargaining to recover competitiveness
- Although it is difficult to predict, **structural reforms could add +0.5 pp to potential growth** or even more.

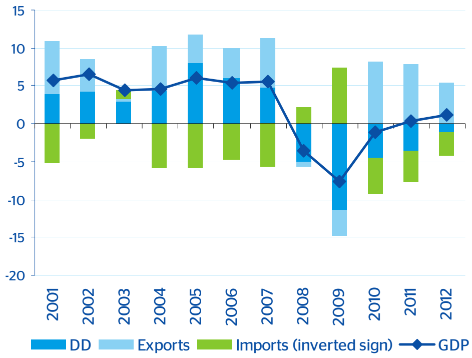
Section 2

Ireland: economic outlook

- **Fiscal adjustment together with a drop in confidence** will lead to economic stagnation this year
- **It is expected a sharp drop in domestic demand** in a context of a high private and public deleveraging over the medium term
- **The role of exports is crucial for the recovery.** For the moment, they are responding

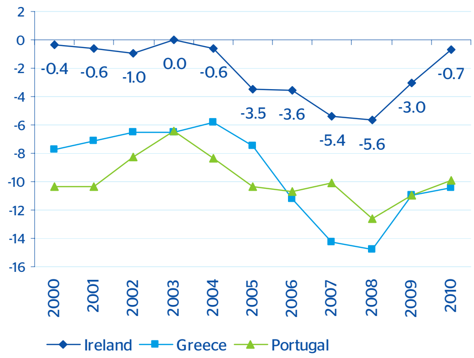
Ireland: GDP growth and contributions

Source: xxxxxxxxx



Current Account (% GDP)

Source: Eurostat, IMF and BBVA Reaearch



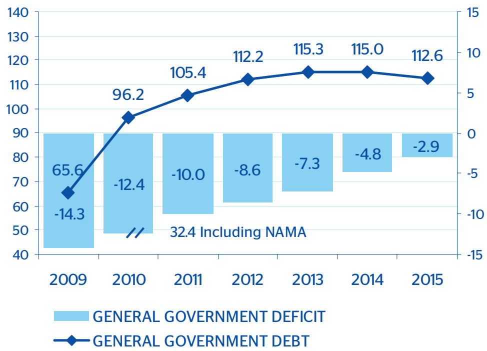
Section 2

Ireland: fiscal outlook

A banking crisis that has led to a sharp deterioration of fiscal accounts

Ireland, GG deficit and debt (% GDP)

Source: Eurostat, IMF and BBVA Reaearch



- During 2009 and 2010 some financial institutions received Government capital injections. **The increase in spending of 20 pp of GDP in 2010 is explained by the aid pledged to banks of EUR 32 Bln**
- The **deficit reduction pace** (excluding the one off of 2010) is still relatively slow, with the deficit projected to be below 3% only in 2014
- The **central budget deficit was clearly down year-on-year in April.** Tax revenues rose markedly in April

Section 2

Spain: going for fiscal rigour

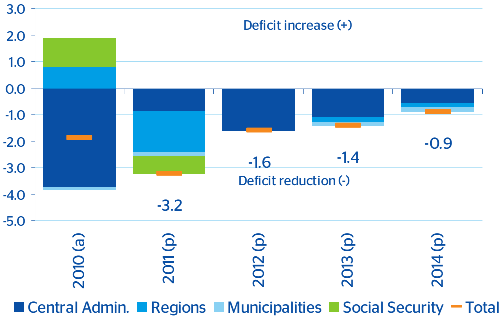
Meeting budget targets would significantly reduce risk premium

- **The objective is ambitious:** the public administration deficit must be reduced by more than 6pp of the GDP to achieve the target of -3% of the GDP in 2013
- **In 2011, this mostly falls in the autonomous communities:** the autonomous communities will have to reduce their deficit by 1.5pp and make 90% of their 3 year adjustment in 2011 in order to ensure attainment of the -3% GDP target by 2013

Contribution to fiscal adjustment *

(GDP pp)

Source: BBVA Research, using finance ministry data

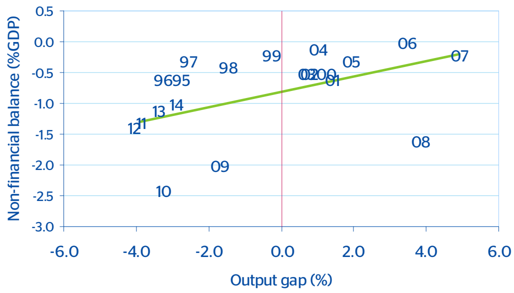


(*) Excluding negative clearance from regional financing

Autonomous communities: budget balance* vs. output gap

(GDP pp)

Source: BBVA Research, using finance ministry data



(*) Excluding negative clearance from regional financing

Section 2

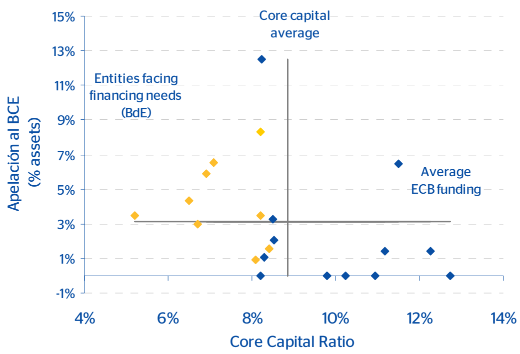
Spain: financial restructuring

Capital needs are limited (3-5% of GDP) and are concentrated in a narrow number of entities (one third of the system's assets)

Spanish institutions: core capital ratio and appeal to ECB (December 2010)

(% of GDP)

Source: BBVA Research based on data from the Bank of Spain, CECA and individual sources



* Including 21 Spanish financial entities

The entry of private capital in those entities with financing needs should take place as soon as possible, in order to achieve a quick and definitive solution

The objective of restructuring must be a financial system comprised of solvent and competitive entities subject to market discipline

Section 2

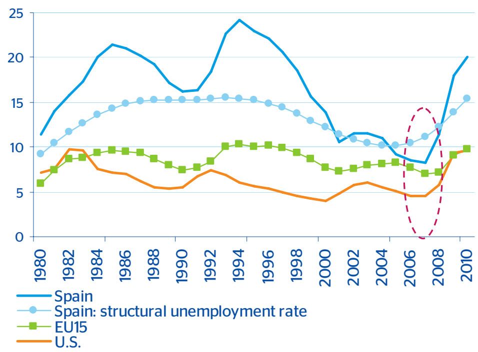
Spain: Growth and job creation

Increased unemployment rate, structurally high ...

Unemployment rate (% of labour force)

(% of GDP)

Source: BBVA Research based on INE and AMECO data



..., driven by massive job destruction, caused by:

1. Downsizing of property sector
2. Concentration of adjustment in the extensive margin (employment)
3. Inadequate wage-setting mechanism

High elasticity of employment and unemployment rate to GDP

Solution: reforms in labour markets and in those for goods and services

3 Annex

[See index]

Section 3

Eurozone

Euro Area (YoY)

Source: BBVA Research

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

(*) Contribution to GDP Growth

Section 3

Germany

- **Recovery remains robust, building up sound fundamentals** for a more broad-based growth (extended to domestic demand)
- **Exports will continue to benefit from a robust demand from emerging economies,** but net exports contribution should decline as a result of greater dynamism in imports
- **Inflation should revert below 2% next year.** Evidence suggests that the risks of an inflation spiral following the oil prices shock are still distant

Germany: GDP Growth and Inflation Forecast

Source: BBVA Research

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

(*) Contribution to GDP Growth

Section 3

France

- **Moderate and balanced growth**
- **The growth pattern will continue in the forecast horizon,** with domestic demand supporting the sustainability of the recovery. The strength of external demand has been felt less, given the lower degreee of openness of this economy
- **The challenge to reduce the fiscal deficit is important,** as most structural measures have still to be pinned down

France: GDP Growth and Inflation Forecast
Source: BBVA Research

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

(*) Contribution to GDP Growth

Section 3

Italy

- **The sluggish recovery continues,** as structural weakness continues to weigh on activity
- **Public debt is high (close to 120% of GDP) but the deficit is relatively small,** thanks to the absence of fiscal stimulus in the wake of the recession, and to the absence of housing bubble

Italy: GDP Growth and Inflation Forecast

Source: BBVA Research

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

(*) Contribution to GDP Growth

Section 3

Spain

- **Slow recovery, positive differentiation against rescued countries**
- **The growth pattern continues based on the strong momentum of external demand,** while domestic demand remained weak
- **Ongoing adjustment of economic imbalances**

Spain: GDP Growth and Inflation Forecast

Source: BBVA Research

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

(*) Contribution to GDP Growth

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