BBVA | RESEARCH

Economic Outlook

Europe

Third Quarter 2011
Economic Analysis

- **Strong global growth in the outlook** with politically-driven downside risks.
- **A long-term fiscal consolidation plan in the US is needed** Mostly short-term fixes are not enough.
- **It is high time to address solvency concerns in Europe** Positive measures taken on July 21 need to be advanced further, as financial tensions become more systemic.
- **The economic recovery stepped down a gear in Q2 but will go on at a moderate pace,** with continued differences across countries.

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Closing date: August 3, 2011

1. Drivers of economic activity in the eurozone

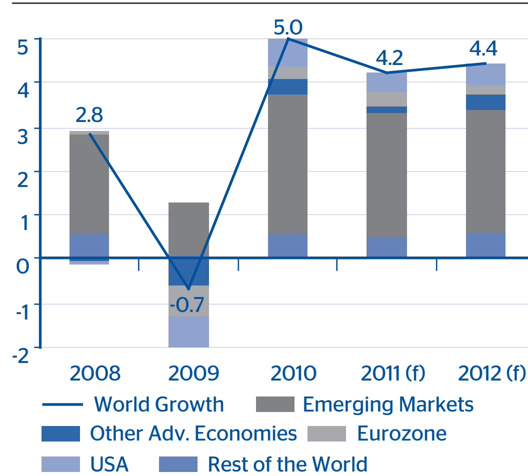
Growth drivers have barely changed

Activity in the Eurozone has been decelerating in recent months. This is not due to a substantial change in those drivers that underlie growth, but rather as a result of a moderation towards potential growth after the strong expansion observed in the first quarter of 2011, which can be attributed to temporary factors and was therefore not sustainable.

Growth in the region as a whole continues to benefit from the strength of global demand, especially in core countries led by Germany. In addition, growth in these countries is pulling exports from the periphery of the area, being currently their main growth driver. Looking ahead, the global economy will continue to grow at a robust pace, despite the deceleration observed in the second quarter, mostly in the US (but also in some emerging countries). This global deceleration responded mostly to temporary factors (the supply chain disruptions linked to the tsunami in Japan and bad weather), and therefore we estimate that the global economy will continue to grow strongly, at 4.2% in 2011 and 4.4% in 2012 (Chart 1). Still, the risks surrounding this scenario are mostly tilted to the downside. One is the fact that the recent soft patch in the US shows that the foundations of the recovery are weak, and the increased uncertainty could end up weighing negatively on confidence. Another is linked to emerging economies, where worries about overheating are fading while economic policies are tightening, although they continue to be clearly lax.

Chart 1

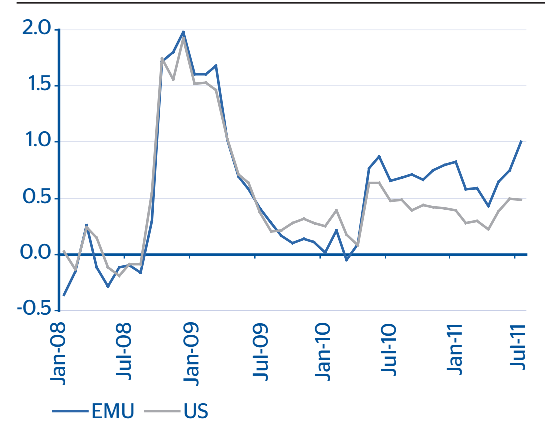
Global GDP growth and contributions



Source: BBVA Research and IMF

Chart 2

BBVA Financial Stress Index



Source: BBVA Research

Regarding oil prices, after the very strong acceleration at the end of 2010 and the beginning of 2011 due to geopolitical factors, they seem to have reached their peaks at the beginning of the second quarter, as they have shown some moderation in recent months. Such evolution is in line with our previous scenario, and suggests that this moderation will continue in coming months, in line with expectations. Despite this, oil prices continue to be high and could be a problem for the recovery. However, as we calculated for our previous publication, the impact will be limited and should be felt mostly next year.

As a consequence of the increase in the price of raw materials, inflation in the Eurozone accelerated rapidly, mostly because of the direct effect of energy prices, but also through direct effects on other products that use energy as an important input. This evolution of inflation, together with a recovery somewhat faster than expected, favoured the decision by the ECB to start tightening monetary policy in April (Box 1). However, given the weakness of activity in the second quarter, financial stress and debt-related problems in some countries, we still see a very

gradual pace of rate hikes. In addition, the differences in monetary poly across regions, with the ECB a step ahead other central banks, will be felt in a more appreciated euro, clearly above its long-term equilibrium level.

In Europe there are additional idiosyncratic factors that have also been determinant for the pace of recovery. One is the high level of deficit and cumulated debt by some countries after the deterioration of public balances linked to the crisis and the fiscal stimulus implemented since 2009, which have required hard fiscal consolidation programmes in some countries to ensure debt sustainability and retain market access. These programmes have had a negative impact on domestic demand in most of the European periphery. Another factor is the accumulation of private sector imbalances in several countries before and after the start of the crisis, which are also a drag for growth. Both in Europe and the US, fiscal concerns pose big challenges for policymakers. As solvency concerns have not been fully addressed, the sovereign debt crisis in peripheral Europe intensified (Chart 2), with the risk of it becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not being put in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations turn just to short-term fixes but not to a long-term consolidation plan. This would increase the chances of a sudden spike in long-term yields in the US.

In general, all these growth drivers have not changed since our last publication, and therefore our view on the prospects of the Eurozone economy remains mostly the same. In particular, World growth has only been revised slightly downwards, while the rate hike cycle by the ECB has been only put forward by one quarter. Fiscal consolidation programmes proceed broadly as expected, although some further measures have been announced to ensure the fulfilment of fiscal targets. All in all, all these factors should to detract much more than one decimal point to growth, both in 2011 and 2012. The main novelties are linked, however, to the evolution of the sovereign debt crisis in Europe, which are described in the following sections.

The largest uncertainty for the recovery derives from the sovereign debt crisis, which has worsened over recent months

Governance reforms approved in the March meetings of the European Council provided only partial solutions to the crisis in the EU periphery and did not allow a reduction in financial stress. On the contrary, this stress increased due to the lengthy process to provide a second rescue package to Greece, which triggered a contagion effect to large countries in the Eurozone, such as Spain and Italy. In particular, the EU Council summits of 7 and 24 March designed the Euro Plus Pact to reinforce structural reforms in European countries, provided further steps in reforming the Stability and Growth Pact to strengthen the control over public deficits and especially to include the vigilance on other macroeconomic imbalances, and provided for the creation of the European Stability Mechanism (ESM) as a permanent stability fund to substitute the current EFSF as from mid-2013. But these steps ahead did not reduce market strains, as the fear of a restructuring of private debt after 2013 persisted. On the one hand, the solvency problem of Greece was still open; on the other, the declarations of EU politicians and the measures taken related to the ESM made it clear that the intervention of the official sector would be accompanied by a private sector participation (PSI) in any definitive solution to the debt problems in peripheral countries. The perspectives of a restructuring in the medium term with a still undefined participation or private investors left these weary from those countries whose solvency is put into question by markets –Portugal and Ireland, as well as Greece.

Over the past two months the situation worsened as it became clear that Greece needed a new financial aid package. The original rescue plan for Greece required the return of Greece to markets as soon as the first quarter of 2012, something that was clearly not possible under prevalent market conditions. Hence this required further public aid. The updates of deficit and debt targets, due to historical revisions and the lack of compliance in Greece, did not help either.

The situation started to be solved after the approval by the troika of the quarterly examination of the progress of Greek reforms, which was need to obtain the next tranche of the aid programme, something which was not obvious given that Greece had missed part of its fiscal revenue targets (despite the very strong adjustment carried out in 2012, equivalent to 8 per cent points of GDP, the largest annual fiscal adjustment by an European country ever). Despite this, the approval of the release of the corresponding tranche of aid due for mid-July was delayed and added to market uncertainty, as the IMF rules allow it to disburse aid money only when the financial needs are covered for the following 12 months –which was not the case, given that the part to be

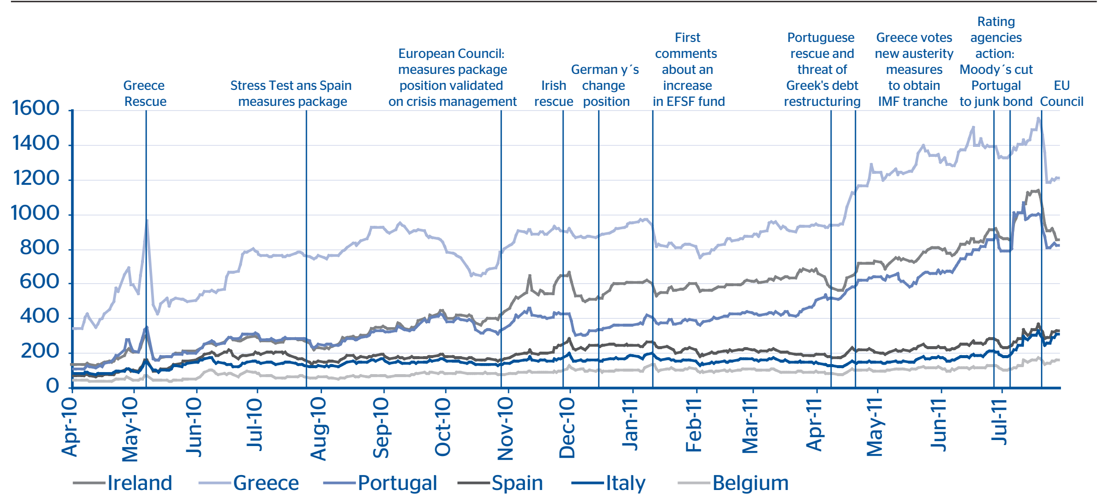
covered by markets was not available and had to be substituted by the new EU/IMF package. This circularity was finally solved through some forbearance on the side of the IMF, which approved the disbursement with a soft compromise by the EU to design the second rescue package for Greece.

By the end of July the Greek parliament approved the laws to fulfil the new conditions needed for the troika to provide a second aid package. The new programme of fiscal measures incorporates an additional adjustment of € 26 billion until the end of 2014, together with a privatization programme estimated at € 50 bn until 2015 (which is probably too optimistic in its estimates of revenues, given current market conditions). The process of parliamentary approval was traumatic, and the laws were passed by a small margin of votes, after strong tensions both in the streets and among Greek political parties and government. The absence of a plan B (any plan to continue providing aid to Greece was conditional on the adjustment) resulted in a strong contagion to other peripherals.

An additional stress factor during the first weeks of July was the slowness of EU authorities in approving the new aid package to Greece, and the insistence in involving the private sector in financing it with modalities that have been debated throughout all this time, generating uncertainty. Although it was clear that the troika was going to provide the necessary funds, the extent of private participation, its implications on a possible declaration of default of Greek debt by rating agencies and even the possible trigger of a credit event in the CDS market (with the spectre of Lehman Brothers looming in the background) led to an important contagion to the rest of the periphery, including this time Italy and Spain, which implied the risk of a systemic crisis in Europe. The spreads of these two countries rose during July from a minimum of 183 and 235, respectively, to maximums of 332 and 367 during the third week of the month.

In addition to this, there was a reaction by the Italian government to accelerate the approval of the measures to reduce the deficit to zero by 2014. Despite the fact that the Italian deficit is relatively low (4.6% of GDP in 2010, well below the rest of the peripherals and France), the fact that the bulk of the adjustment is delayed until 2013 and 2014, together with political uncertainties hitting the government coalition, was not well received by markets.

Chart 3
10Y Spread vs. Germany



Source: Bloomberg

Measures taken at the 21 July EU summit are clearly positive

By the end of July the high level of financial stress led EU authorities to accompany the second rescue package for Greece with a series of reforms on the European rescue fund (EFSF) and with the improvement in the conditions of its loans which could be the basis for a solution of the sovereign crisis, even if there are still important challenges to face.

The main measures approved were the following:

- Second rescue package for Greece, with an official contribution of €109 bn. It is expected that the IMF will continue participating in the programme, and in fact the Fund has released a note signalling that it will do so.

- Softening of the conditions of official loans to Greece, Ireland and Portugal (the other two rescued countries). The maturities of the loans will be between 15 and 30 years, and interest rates will be linked to the ones of the Balance of Payments Facility by the IMF, which at present is around 3.5%. This rate will never be below the financing cost of the EFSF. In addition, for Greece there is a grace period of 10 years for new debt. These conditions imply a very substantial improvement with respect to present conditions (maturities of 7.5 years and rate around 5%).
- A substantial flexibilization of the EFSF, which from now on can be used for bond purchases in the secondary market (in exceptional circumstances and under control of the ECB), including debt of non-programme countries (and therefore of Italy and Spain). The EFSF can be also used to make loans to countries (including non-programme countries) with limited conditionality, similar to the Flexible Credit Line by the IMF. It can also be used by countries to prop up their banking system, including also all the Eurozone countries. In this way, the EFSF acquires a capacity to act in a way that may avoid contagion. Some of these measures had been so far been rejected by Germany and other European countries.
- Private sector involvement: It will be articulated through different instruments. On the one hand, through debt buy-backs, with a target of € 12.6 bn. In addition, there will a menu of options, including debt exchanges and debt rollovers, at par and below par, which on average will imply a net present value loss of 21% for the private sector. The participation will be voluntary, and it is expected that it will be accepted by 90% of bond holders. Overall, the participation of the private sector is estimated at around € 50 bn until 2014 and more than twice that until 2019.
- Implications for Greek collateral: The private involvement will imply almost surely a declaration of selective default of Greek debt by rating agencies. For these bonds to be discounted by Greek banks at the ECB, the ESFS will provide the necessary collateral through guarantees. The ECB president Jean-Claude Trichet has declared that the institution will accept such guaranteed bonds.

One additional and important element of the communiqué is a clear commitment that private participation will apply only to the Greek case, which provides signal that Europe considers that the problems of the rest of periphery countries are liquidity problems and not a solvency issue.

Our evaluation of this agreement is overall positive. There has been an important decision to flexibilize the EFSF beyond what could be expected, a decision which was not made in March summits, which the new conditions for official loans are much more favourable tan before. The EFSF and its future substitute as from 2013, the ESM, could constitute at some point the basis for a deeper fiscal integration in Europe, which coupled with the issuance of eurobonds would imply a definitive solution of the present debt crisis.

On the other hand, the agreement leaves some unresolved problems. On the one hand, the capacity of the EFSF could possibly be insufficient to deal with an eventual attack to Italian or Spanish sovereign debt. The proposals to expand this capacity have not been adopted in the summit. On the other hand, the Greek debt to GDP ratio will continue to be very high, far from “safer” levels close to 100%. Markets will continue to doubt about the solvency of Greece, which could result in contagion to other countries. Finally, the risk of non-compliance by Greece of fiscal conditions attached to the rescue plan is still very high, and compliance will continue to be assessed by the troika on a quarterly basis. Despite the fact that during the summit an investment plan has been approved for peripheral countries (with no specifics on the funds committed) in order to alleviate the impact of fiscal consolidation on growth, the size of the adjustment still to be made by different countries is still very large.

The debt crisis in the periphery will have some impact on the recovery of the area

Our base scenario incorporates the assumption that stress levels in the Eurozone will take time to flex down, something that will happen once doubts on debt sustainability in the area dissipate. All this will translate in a financial restriction somewhat higher than the one projected three months ago. This, together with the persistence of the main growth drivers described above (oil prices, financial consolidation, monetary policy, external demand, exchange rate) lead us to revise slightly downwards our growth projections for 2012.

Box 1. ECB: sticking to a pre-emptive approach

Over the past few months the European Central Bank (ECB) gave clear indications that it is sticking to a pre-emptive approach to monetary policy. Comments by ECB members during this period were on the hawkish side and references to a path of normalization were brought up eg. "if the economy continues to grow" more gradual moves are possible as "the very low level of interest rates that we have does not seem fully justified" (Bini Smaghi); "in the face of higher inflation risks, there is a greater need to proceed with monetary-policy normalization" (Draghi). Consistent with this, the ECB flagged a rate hike in June in spite of widening peripheral spreads as Greece's tensions mounted and with contagion spreading for the first time to Italy, it delivered the 25bp hike in July. By doing so, the ECB showed again that its main focus is on inflation (risks) and that it will only alter its monetary policy decisions because of sovereign related developments if they affect its assessment of risks to price stability.

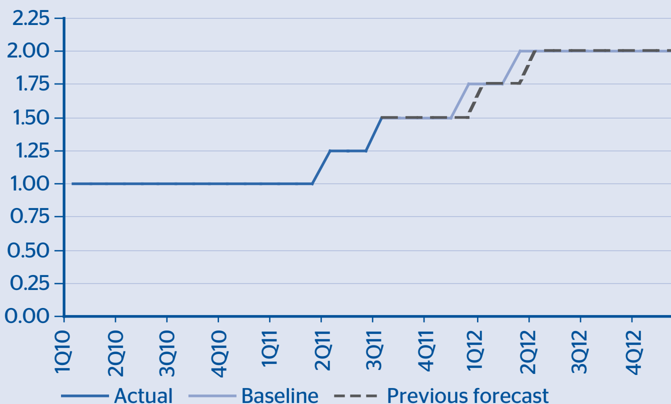
It is clear that the ECB still does not feel comfortable with the level of rates which they continue to view as low. Even taking into account the latest 25bp hike (which brought the policy rate to 1.50%), by keeping a hawkish tone, still seeing the risks to price stability as tilted to the upside and continuing to label monetary policy stance as "accommodative", the ECB suggests that more hikes are likely. A few months ago, our bias already was that the ECB might bring forward our expected hikes for Q1 and Q2 12. In view of recent developments we changed our forecast only to allow for those hikes to come sooner: we now expect another 25bp hike in Q4 and one more in Q1 12.

However, we continue to think that monetary policy normalization should proceed relatively slowly, and thus the monetary stance will remain accommodative throughout 2012. We maintain our call of a policy rate at 2.0% at end-2012.

We believe that once the main policy rate reaches that level the ECB will feel more comfortable and will see no need to continue with the current pre-emptive approach as current low risks of second-round effects will diminish even further. On the one hand, growth will slow and the outlook might face increasing risks to the downside –although the ECB already acknowledge a Q2 slowdown in its last statement, it was downplayed somewhat as the "positive underlying momentum... remains in place". On the other hand, as of Q1 12 inflation will likely begin to trend to the downwards at the same time as inflation expectations will remain stable. In that context, the ECB could see risks to price stability as more balanced and might decide to proceed more slowly with its current desire to normalize rates. Thus, it may prefer to adopt a wait-and-see approach (as opposed to the current pre-emptive approach) for some time until uncertainties are dispelled (probably in early-2013) and a rate normalization process can be resumed.

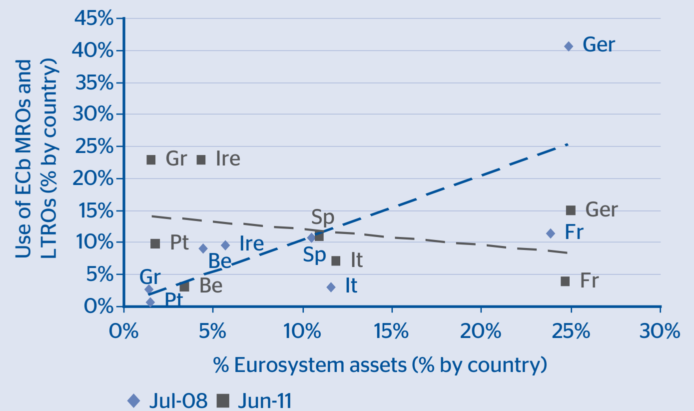
The fact that the ECB seems to be fully focused on inflation does not mean that the role of the peripheral debt crisis is gone. As a permanent solution to financial challenges is still not in sight, the ECB will have no choice but to continue with liquidity non-standard measures. Market conditions forced the ECB to delay again the "phasing-out" of the exceptional liquidity measures: the Council decided to continue with a fixed rate full allotment procedure in the refinancings during Q3. Going forward, loose liquidity policy will be maintained –as tensions are unlikely to fade away in the near-term– either with the fixed rate full allotment procedure or with a new mechanism to handle liquidity supply for "persistent banks" which up until now is a "work in progress". But the fact is that dependency on ECB funding will continue in the following quarters and therefore, ECB's loose liquidity provision will carry on for as long as necessary.

Chart 4
ECB: Forecast



Source: ECB and BBVA Research

Chart 5
ECB Funding



Source: ECB and BBVA Research

2. Recent trends and projections

2.1 Eurozone

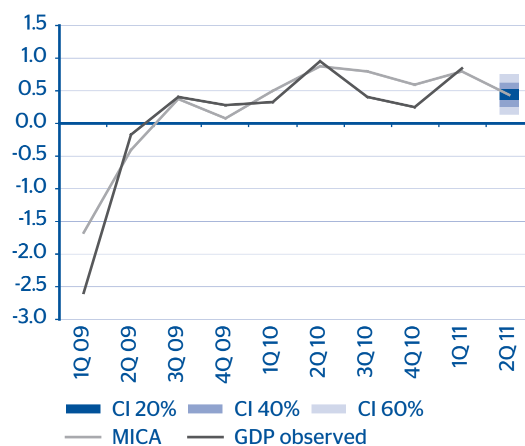
The recovery in the eurozone has stepped down a gear in Q2, with both exports and industrial sector loosing steam

The eurozone GDP detailed results for Q1 confirmed that GDP grew by 0.8% q/q in Q1, driven by a stronger domestic demand than anticipated, mainly supported by short-lived rebounds of both investment and public expenditure. Private consumption grew steadily, but net exports contribution was more moderate. Exports continued to grow robustly, but offset by the dynamism of imports, supported by the incipient recovery of domestic demand.

Nonetheless, as both public and investment rebounds were temporary, economic activity has decelerated during Q2, as expected three months ago. In fact, confidence data for the current quarter have confirmed this deceleration, while hard indicators up to May are somewhat gloomier. PMI's fell sharply and more than expected in June. The slowdown in activity seems to be broad based across countries and more accentuated in manufacturing, suggesting that industrial expansion stopped in most of the eurozone, except in core countries with a more moderate growth. In fact, industrial production and orders confirm the slower tone in activity in Q2, partly explained by lower demand form abroad. Indeed, eurozone exports increased in May, against expectations, but its slowing trend continues. In addition, trade data suggest that net exports could contribute marginally to GDP growth in Q2. Regarding households' spending, retail sales declined in May, offsetting the gain observed in April, and showing that private consumption could have moderated in Q2. Overall, these signs were widespread across member states, while consumers' confidence also supported this view.

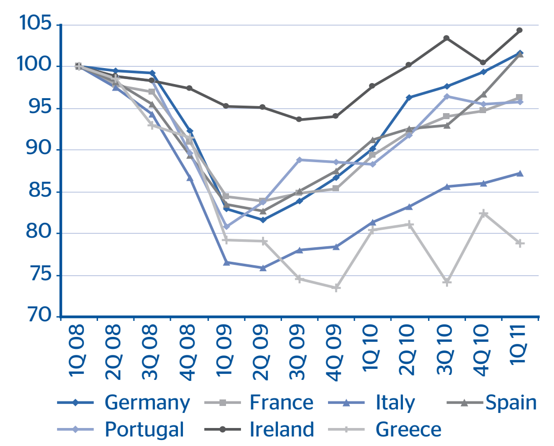
Overall, short-term model for the eurozone foresees growth at 0.4% q/q in Q2, in line with our baseline scenario of slower growth for the rest of the year, after a strong Q1 due to temporary factors. Uncertainty has increased, however, linked to possible faster deceleration of global demand than anticipated as well as to the still unresolved sovereign debt crisis. In addition, there is further evidence of a multi-speed recovery, mainly determined by the evolution of domestic demand. The latter significantly lags behind in peripheral countries, as fiscal consolidation efforts intensify and de-leveraging continues.

Chart 6
Eurozone: GDP growth and MICA model forecast (% q/q)



Source: BBVA Research

Chart 7
Exports y country (Index, 1Q 2008=100)



Source: Eurosat andBBVA Research

Exports continue to support the recovery, but moderating. They remain as the main driver in the periphery

The strong recovery in exports during the early stages of the upswing has led them to achieve the pre-crisis levels, showing a clear slowdown in the second half of last year, although still growing at robust rates, The latter coupled with a greater dynamism in imports, due to the nascent recovery in domestic demand, has resulted in a marked reduction in the contribution of net exports to economic growth. For the second quarter, the available short-term indicators, both the EC survey and trade data, are pointing in the same direction. Looking forward, both EC and PMI surveys are not too encouraging, as they showed that export order books decline further, suggesting that the declining trend is likely to remain in coming quarters. Although uncertainty remains elevated and recent data suggest that global growth is slowing, exports are likely to growth over the forecast horizon, supporting the recovery in coming quarters, especially in the periphery.

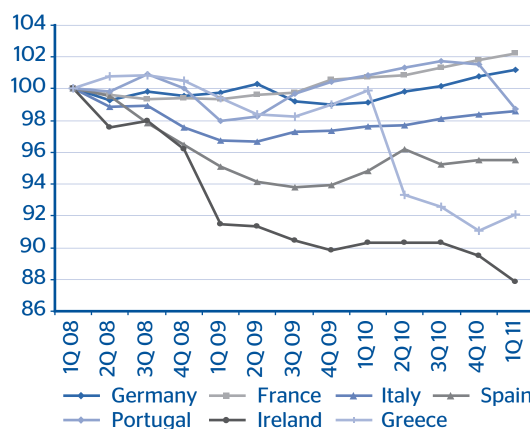
Domestic demand is gaining importance

As the recovery is consolidating, inventories and net exports are contributing relatively less to GDP growth, signalling an increasing role for domestic demand, albeit gradually and moderately, as investment continues to benefit from emerging economies' demand that could end up positively affecting the labour market and thus households' spending. In particular, the largest increase in the contribution to GDP growth was recorded for domestic demand over 2010, and the strong quarterly growth observed in Q1 was mainly due to domestic demand components, although it is to be noted that it could be temporary.

Drivers of private consumption continue to build up, but without clear signs of decisive recovery, as increasing uncertainty on economic outlook due to still unresolved sovereign debt crisis is weighing on consumers' confidence.

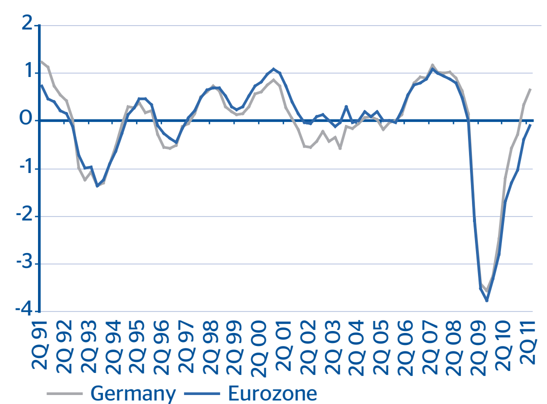
Private consumption has been growing at steady and moderate rates throughout 2010 and early 2011, supported by a better performance in the labour market that resulted in an improvement in households' disposable income, somewhat depleted by the rise in inflation. In addition, consumers' confidence also enhanced significantly, encouraging their consumption. Available data for Q2 point to some moderation in private consumption, although we continue to see relatively resilient household's consumption over the forecast horizon due to improving underlying drivers. Nevertheless, we must highlight some risks of a sharp drop in consumers' confidence, as observed in the last recession, resulting from the fragility of the eurozone economic recovery if financial and sovereign debt crisis would remain unresolved. Again, the divergence across member states is apparent, with consumption remaining very weak or even contracting in the periphery, hampered by tough fiscal adjustment plans combined with the need to adjust private sector imbalances and the strong deterioration in labour markets.

Chart 8
Private consumption by country (Index, 1Q 2008=100)



Source: Eurostat and BBVA Research

Chart 9
Current level of capacity utilization (standardized data)



Source: European Commission and BBVA Research

Investment is likely to grow further, as capacity utilization has reverted to long-term average and financing conditions remain still favorable

Investment in both equipment and other products has clearly benefited from strong demand from abroad since the beginning of the recovery, mainly from emerging economies. In particular, investment in equipment has recovered nearly half of the accumulated fall during the crisis, while investment in other products has been fully recovered. Investment growth is expected to have continued over Q2 2011 and will continue over the forecast horizon, since much of the investment plans were postponed as a result of the crisis, while capacity utilization has already reverted to long-term levels. As a result, firms have to invest further to meet still robust external demand and incipient domestic one. Additionally, favourable financing conditions, despite recent interest rates hikes by the ECB, should also support new investment plans, while credit standards seem to have been relaxed recently. However, investment in construction, both housing and other constructions, is likely to be decline again in Q2 after the rebound observed in the previous quarter due to transitory factors. Overall, investment in construction is likely to recover very slowly, negatively affecting by fiscal consolidation plans, especially in infrastructure.

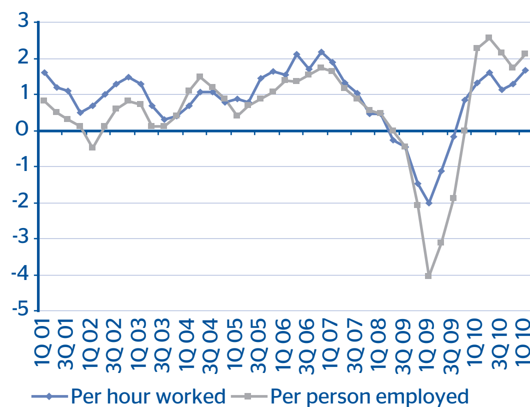
Employment was flat in Q1, as expected, suggesting that high uncertainty continue to weigh on firms' expectations

Although the recovery began almost two years ago, job creation has been very moderate, barely 0.6% after a cumulative fall of about 2.5pp. Underlying this performance is that employment was also very resilient during the recession, ravaging mush less employment than output as companies faced falling demand through the reduction of hours per employee (labour hoarding) rather than by cutting jobs, encouraged by governments in some member states. As a result, productivity declined sharply during the downturn, while firms have increased productivity over the recovery without affecting the demand for employment. For this reason, the unemployment rate has remained relatively stable at high levels (10.2%), reaching a local peaked in Q3 2010, but dropping only a couple of tenths up to Q1 2011. The high rate of unemployment has resulted in a limited increase in the compensation per employee.

The most recent soft data continue to point that the improvement in hiring intentions is limited and thus unemployment declining should be very slow. However, productivity data per employee and per hour worked have returned to pre-crisis levels, so increasing activity would have to be met with an increase in employment. Given the expected economic slowdown and increasing uncertainty about the economic outlook in coming quarters, we do not expect a significant reduction in the unemployment rate over the forecast horizon.

Aggregate data mask significant differences between member states, with unemployment declining more intense in core countries with strong economic growth and labour market more flexible, while unemployment being more persistent in those countries (peripheral) that are carrying out strong structural adjustments.

Chart 10
Eurozone. Productivity (% y/y)

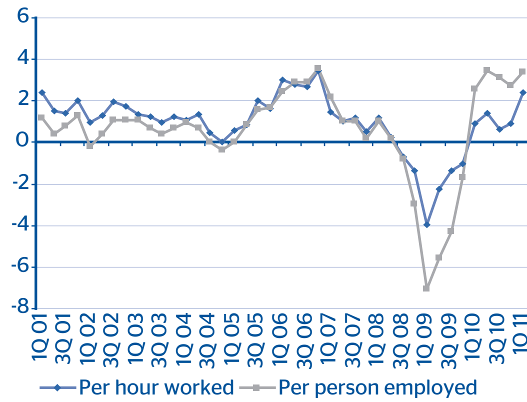


Source: Eurostat and BBVA Research

Chart 11
Spain. Productivity (% y/y)

Source: Eurostat and BBVA Research

Chart 12
Germany. Productivity (% y/y)



Source: Eurostat and BBVA Research

Chart 13
Portugal. Productivity (% y/y)

Source: Eurostat and BBVA Research

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

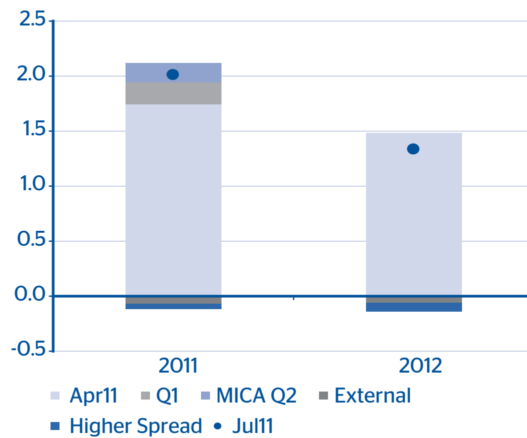
The eurozone recovery is expected to be more muted than the average of previous upturns, as financial downturns are deeper and longer than usual (Box 2), combined with other factors that continue to restrain domestic demand, as the correction of severe imbalances in some member states as well as increased financial strains stemming from the crisis of sovereign debt.

For 2011, we continue to see a clear slowdown in economic activity in Q2 after a strong and unsustainable rebound observed in Q1 that responded largely to temporary factors. However, we have revised our GDP growth forecast for the whole year slightly upwards, by +0.3pp. to 2% mainly due to carry-over effect of both domestic demand stronger than anticipated in Q1 (+0.2pp) and stronger growth in Q2 (+0.2pp). It is to be noted that most or the drivers behind our scenario (oil prices, fiscal adjustment and monetary policy) have evolved in line with expectations three months ago, while a further slowdown in the global recovery (-0.1pp) and a larger increase in spreads (-0.1pp), mainly focused in the periphery, should have a limited impact on economic growth over the second half of the year. Our forecasts point to a lean slowdown in quarterly GDP growth over the period. Therefore, despite the slowdown in exports, they will continue to grow at robust rates and being a key driver on the sustainability of the recovery. External demand will continue to support the upswing in private investment that will lead a moderate growth in employment, strengthening the fundamentals of households' spending. In short, the recovery of both investment, especially, and private consumption will result in a larger contribution of domestic demand, while net exports will contribution will decline slightly due to a slowdown in exports more intense than that in imports as response to increased domestic demand.

For 2012, GDP growth will decelerate to 1.3%, somewhat more intense than estimated three months ago (-0.2pp). Underlying this slowdown would be the limited impact of higher oil prices, both direct effect and indirect effect via higher inflation and interest rate that end up affecting adversely both private consumption and investment. We must also add the effect of higher spreads in peripherals (-0.1pp), mainly in Italy and Spain. On the external side, slightly slower global economic growth coupled with a slight appreciation of the euro could be reflected in a lower contribution of net exports (-0.1pp). Furthermore, those factors determining a slower recovery pace than in previous cycles persist, as de-leveraging in both public and private sector will continue, as well as the uncertainty in the banking system resulting from the financial and sovereign crisis.

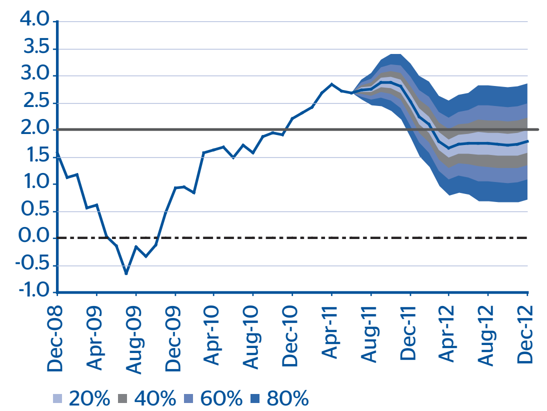
Across member states, aggregate figures for the eurozone continue to hidden significant differences in 2011 as a result of disparate performance of domestic demand. Nevertheless, divergence is expected to diminish, resulting from lower growth in core countries – that will revert towards their potential growth – and faster growth in peripherals, given the most of the fiscal adjustment has been focused in 2010 and 2012.

Chart 14
Eurozone: GDP growth (Annual average growth, %)



Source: BBVA Research

Chart 15
Eurozone: HICP (% y/y)



Source: Eurostat and BBVA Research

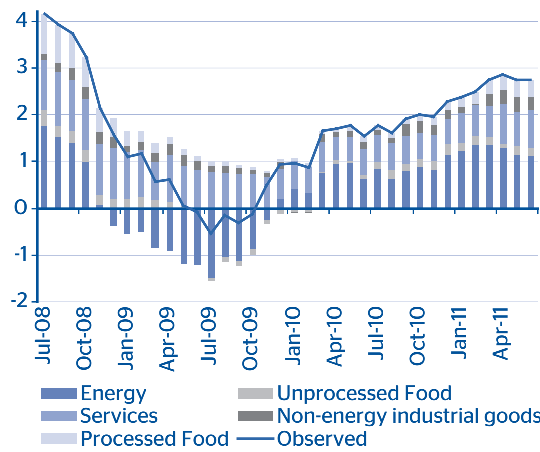
The significant acceleration in both headline and core inflation at the beginning of the year halted in Q2. There are no signs of second round effects

Both headline and, especially, core inflation accelerated further in April, continuing the upward trend observed at the beginning of the year. Underlying this acceleration was the seasonal effect of Easter and the rising prices on new seasonal products. The latter was proved in May and June, as headline and core inflation remained broadly stable in both months. Overall, the stabilization observed in Q2 reflected the lower contribution of energy prices to annual inflation rate that was offset a higher contribution of prices of core components. In addition, the still energy inflation rate explains virtually half the headline inflation rate in Q2. Nevertheless, June's figures were somewhat better than expected with a lower acceleration in core inflation than expected, suggesting that indirect effects could be fading faster than anticipated resulting from resurfaced fears surrounding sovereign debt crisis that end up weighing on consumers' confidence.

Across member states, the acceleration shown in both headline and core inflation at the beginning of the year was widespread, as well as the stabilization observed in both May and June. In particular, in some member states, inflation declined slightly by end-Q2. The greatest increase in core prices in the second quarter was recorded in Germany and Italy, but while the former could arise fears about second round effects, due to the strengthen of the recovery and labour market improvement, the latter was mainly due to methodology changes in seasonal products. However, there are no apparent signs of second round effect, since wage rises continue to be moderate. In peripheral countries, higher inflation was mainly a result of tax increased on consumption, with a more moderate acceleration in headline inflation excluding these tax hikes.

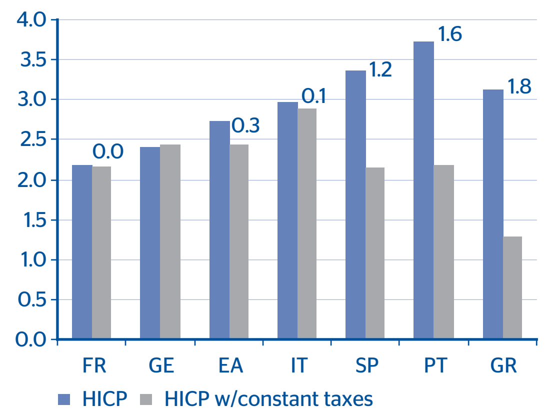
We think that headline inflation could remain broadly stable or even decline marginally in coming months, but increasing slightly further to a rate close to 3% y/y in September and moderating afterwards, due to the expected moderation in energy prices, core inflation is likely to be close to 2% at the end of the year. As a result, the average annual inflation rate would stand well above the ECB's inflation target, at around 2.7%, while core inflation is projected at 1.7% in 2011. For 2012, we continue to see headline inflation reverting to rates below 2%, driven by lower energy commodity combined with a base effect in annual terms. Nevertheless, core inflation is expected to increase slightly as private consumption should remain resilient.

Chart 16
Eurozone: Annual HICP inflation rate. Contribution by components (pp)



Source: Eurostat and BBVA Research

Chart 17
HICP by countries in May 2011 (% y/y, values are differences in pp between rates)



Source: Eurostat and BBVA Research

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

Downside risks on activity are linked to an unsatisfactory resolution of the Greek sovereign debt crisis and potential contagion to other peripheral countries, as well as worse than expected fiscal consolidation outcomes in smaller countries. In addition, concerns from the US fiscal performance are arising recently. A deterioration of the geopolitical situation in MENA countries would also be a source of risk. On the upside, the recovery of domestic demand in the core of Europe could be stronger and more protracted than expected, leading GDP to growth rates more in line with previous cycles.

On inflation, we continue to see upside risks to inflation coming primarily from the higher commodity prices, especially from food prices, and, to a lesser extent, more apparent second round effects to core inflation in 2012, On the downside, a deceleration of private demand from a sharp decline in consumers' confidence along with a persistent strength of the euro would weigh on inflation.

Box 2. Bank lending and business cycle in EMU: a slow and fragile recovery

The evidence shows that the recent eurozone recession has not been an exception to the norm of other recessions generated by financial and real estate crises. In this box, in order to evaluate the perspectives of the eurozone economy, we disentangle the role of the banking sector lending behaviour from other explanatory factors in the recent performance of consumption and investment, using an improved version of the DSGE model with banking and credit originally developed by Gerali et al (2010).

The economic crisis that took place in 2008 presents some contrasting features with respect to previous economic downturns. In particular, the fall in activity and employment has been sharper and the recovery pace much more moderate than in previous recessions. The financial crisis and the greater interdependence between financial and real economic variables have been at the centre of the recession, changing the transmission mechanism of macroeconomic policies as well as possibly introducing new rigidities in the economy[1].

DSGE models are the most reliable statistical tool to unravel the causal direction of effects among macroeconomic variables in the short and medium term. The model used here incorporates the financial sector and financial decisions of both households and firms with sufficient detail to account for the significant impact of credit on investment and private consumption, as well as for the various demand and supply factors that underlie the dynamics of credit. The model incorporates the following features to capture the stylized facts of the recent EMU downturn: (i) imperfections and rigidities that characterize the functioning of the banking system, good and labour markets, and its dynamics, (ii) restrictions on access to credit by households and firms due to changes in the value of their assets used as collaterals, (iii) minimum capital (prudential and legal) requirements faced by banks, as well as the costs associated to the degree in which these requirements are being met, and (iv) banks' balance sheet identities and, in particular, the possibility of events that will force a rapid restructuring of balance sheets.

The structure and transmission channels of the model are as follows. The economy is populated by "patient households", who save part of their income each period and own the banks and firms in the economy, and by impatient households and entrepreneurs, who borrow money each period to spend more than their income. Both impatient households and entrepreneurs borrow money from lending retail banks (which allows to differentiate between types of credit), while patient households buy deposits from deposit retail banks. Deposit retail banks transfer their deposits to a wholesale bank which provides the funds to lending retail banks, taking care to satisfy the balance sheet identity and accounting for the costs of deviating from the optimal value of the banking capital ratio (banking capital/banking assets), which is given exogenously. Additionally, there exist a production and a commercial sector which employ labour services from households in exchange for wages, which are monopolistically fixed by labour unions. The interest rates are also fixed monopolistically.

Overall, the model, once adjusted to EMU data, allows us to decompose the rates of growth of different macroeconomic variables in terms of the following categories of shocks: (i) financial shocks: those forces that restrict or expand bank's credit supply, (ii). macroeconomic shocks: those forces, not linked to the banking sector, which affect households' consumption and spending and firm's investment. These shocks ultimately determine the credit demand by these agents, and (iii) Monetary policy shocks: unexpected changes in interest rates determined by the monetary authority.

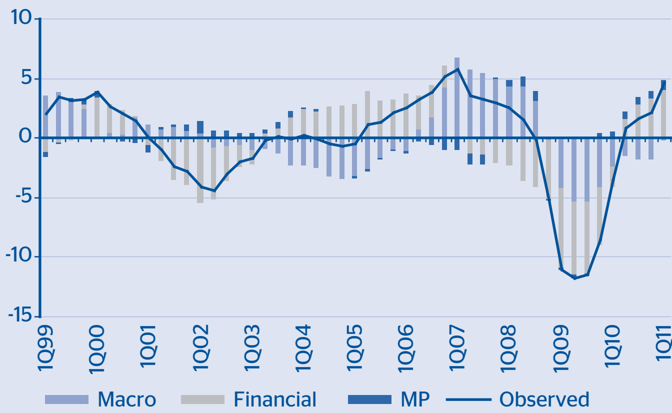
The results from the model are in line with the conventional interpretation of the recent European crisis: tensions in financial markets and banks' losses from subprime credit exposure and from significant write-offs on asset-backed securities caused a widespread credit restriction, which in turn triggered a severe economic downturn. This view is also supported by the evidence provided by the Bank Lending Survey from the European Central Bank: credit standards tightened since the start of the recession, mainly driven by the increasing costs related to banks' capital as well as by difficulties to access financial markets.

We use the historical shock decomposition produced by the DSGE model to quantify the importance of each shock on the dynamics of the main macro and financial variables in the eurozone. In particular, the historical decomposition shows that both financial and macroeconomic shocks were the main drivers of the economic expansion over 2006-2008, but financial shocks explained most of the fall in the recent downturn.

Financial shocks have the largest impact on investment (Chart 18). In particular, the two main financial shocks were those related to firm's loan-to-value ratios, along with, to a lesser extent, mark-ups charged by banks as a consequence of the high uncertainty in the economy, which result in a reduction of loans to companies. However, macroeconomic shocks were the main drivers of the contraction of loans to households, resulting from lower demand for both housing services and consumer goods. In short, the reduced availability of credit in the economy appears to be due to a combination of both supply (affecting investment) and demand factors (in the case of credit to households).

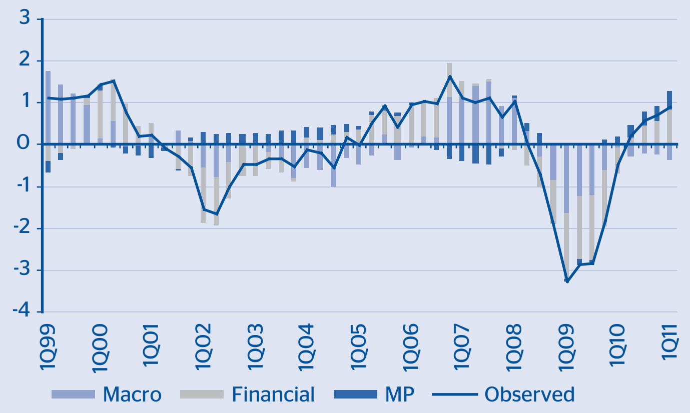
1: Gerali, A., S. Neri, L. Sessa and F. Signoretti (2010): "Credit and banking in a DSGE model of the euro area", Journal of Money, Credit and Banking, 42. In the version used in this note we substitute the standard HP filter by the forecast-augmented HP filter, correcting in this way the distortion produced by the former in the measurement of the situation of the economy in the most recent periods. We are currently working in some substantial extensions of the model as the inclusion of the fiscal policy dimension. For more details, see BBVA Research Economic Watch released in July, 19th.

Chart 18
Investment (% y/y)



Source: BBVA Research

Chart 19
Output (% y/y)



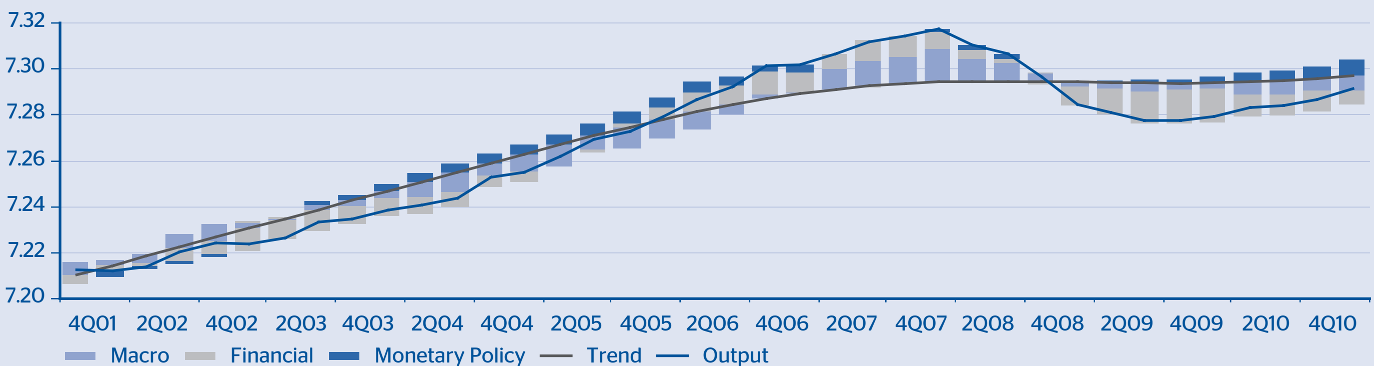
Source: BBVA Research

By mid-2009, the eurozone economy started to recover, although at a much slower pace than in previous upswings. The good news is that the negative impact of financial shocks dampened over the second half of 2009, contributing positively to annual growth rates in recent quarters, partly because banks have not continued tightening credit requirements and partly due to the incipient recovery in domestic demand. The non-standard liquidity measures implemented by the ECB partially restored the normal functioning and the stability of financial markets, providing liquidity into the economy. As long as financial shocks started to affect positively the economy and policy makers began to withdraw expansionary fiscal policies taken to boost the economy, macroeconomic shocks also ended up hampering economic activity (Chart 19). Regarding monetary policy, the sharp reduction in the ECB policy rate resulted in an expansionary monetary policy that supported economic growth.

Nonetheless, despite this recovery, the Eurozone is still far below its potential trend. As a consequence, the output gap is still negative (Chart 20). In addition, the negative impact of both financial and macroeconomic shocks as well as some unresolved problems in the banking sector and higher capital requirements suggest that the economy is still far form reverting to the output path prevalent before the crisis. In particular, the deleveraging process of the private sector could weigh on the recovery in domestic demand. The latter could be one of the main differences with previous recoveries, where a sound financial sector would have provided the credit necessary to sustain the expansion of economic activity.

Finally, it is worthwhile to note that the positive contribution of financial shocks in the recent recovery could be ephemeral and could revert rapidly if the current sovereign debt crisis intensifies (for example, as in the case of a disorderly debt restructuring of the Greek economy), and EMU faces again a Lehman-like global financial shock.

Chart 20
Eurozone: Output, trend and shocks



Source: BBVA Research

2.2 Member States: A closer view

A multi-speed recovery

The aggregate picture masks marked differences in the developments across member states. As already shown in the previous sections, the differences between core and periphery countries in the eurozone have widened once again at the beginning of the year. Divergence increased as a consequence of greater financial tensions in the periphery, the correction of economic imbalances, and fundamentally different fiscal adjustment processes.

Germany: The recovery remains robust, but will lose strength in coming quarters reverting to a more sustainable growth pace

The German economy is clearly benefiting from strong global growth, especially from emerging economies, which has allowed it to grow above its potential, recovering by Q1 the pre-crisis output and employment levels. The strong German export dependence was also the trigger of the severe recession, as output responded primarily to a temporary drop in external demand, while the contraction in domestic demand was much more moderate than in other member states. In addition, Germany had not accumulated significant imbalances in years previous to the recession. The labor market reforms of the early 2000's, combined with the short-term scheme supported by the government, allowed firms to adjust working hours, instead of employees, while the strong upswing has already been felt in new jobs, and, therefore, the drivers of private demand continue to improve. Investment, especially in equipment, continues to grow robustly to face the demand from abroad. Overall, solid drivers for private demand have been built up in recent quarters to support a more balanced growth over the forecast horizon.

The very good results of the first quarter not only confirmed that the German economy recovered from a temporary blip, but it also exceeded expectations. In addition, the Q1 recovery was more broad-based, with a growth pattern shifting towards domestic demand, although exports continued to remain as a key driver for growth. Still, this good performance was a rebound from negative weather-related factors at the end of 2010, especially in construction investment. In fact, soft data available for Q2 show evidence of an expected slowdown, while hard data up to May point in the same direction, although with mixed signs about its intensity. On the one hand, retail sales declined significantly in May, although they are too volatile to draw a clear conclusion yet, as these figures contrast with more positive signs coming from consumers' confidence, and the underlying drivers continued improving. On the other hand, exports rebounded more than expected in May and, although keeping its downward trend, they remained as the key driver for the industrial sector.

Overall, the German economy is expected to continue expanding at steady, but more moderate rates (around 0.4% q/q) in coming quarters, more in line with its growth potential. As a result, the German economy will grow again above the eurozone average, somewhat above 3%. The growth pattern should shift further towards domestic demand. Although exports will continue to benefit from a robust demand for emerging economies, the contribution of net exports is expected to decline as a result of a greater dynamism in imports. For 2012, we see growth slowing again in a process to converge towards its potential rate, mainly supported by domestic demand and a negligible contribution of net exports.

Despite the fiscal stimulus implemented over the crisis, German government did not accumulate a large deficit, unlike other member states, so the recovery will not be burdened by a significant fiscal consolidation. In fact, the government deficit continues to outperform the targets thanks to better than expected cyclical conditions. It is expected to reach a -2% deficit this year, 0.5 pp below the objective. Better than expected tax revenues has led to a domestic debate on whether to reduce some taxes, although this option has been rejected so far by the Finance Ministry. Debt remains high at 83% of GDP after the inclusion of support measures to the banking system totaling 12.4 pp of GDP.

Regarding the evolution of prices, the sharp and worrying acceleration of core inflation up to April seems to have halted in Q2, suggesting that such acceleration responded both to the indirect effects from higher commodity prices and the Easter effect, rather than to stronger underlying inflation pressures. Nonetheless, despite the moderation in energy prices, we continue to see upside risks from potential larger indirect effects in the short-term because of the emerging strength of domestic demand and the rapid increase in capacity utilization. Annual inflation rates

in Germany remain below the eurozone's average. In fact, headline inflation has slowed slightly at the end of Q2, as a result of a moderation in prices of both core and energy components, diminishing concerns about second round effects. We still do not see clear signs of acceleration in wage growth, since most of the salaries were negotiated last year, while they have become more responsive to changes in activity than in prices. In short, we project that German inflation should end up averaging around 2.6% in 2011, similar to eurozone's average, slowing in 2012 to rates slightly below 2%.

France: Moderate and balanced growth

The lower degree of openness of the French economy is being reflected in a slower recovery than that observed in Germany. However, this also explains a smaller drop in output during the recession and, therefore, the French economy has almost recovered the production fall accumulated over the crisis. Overall, French activity has been growing at relatively steady rates around its potential growth since the beginning of the recovery, with a growth pattern that continues to be based on the strength of private consumption and the surge of investment, while the contribution of net exports has been marginal.

This growth pattern was confirmed in Q1, with strong GDP growth supported by dynamic private consumption and restocking process, as well as by a recovery in investment, while net exports remained lackluster. This rebound should have been short-lived after temporary factors damping growth in Q4 2010 (severe weather conditions as well as disrupting strikes). In fact, recent data suggest a significant slowdown in Q2 to rates (of around 0.2% q/q) below its potential growth. Overall, we continue to see French recovery rooted in domestic demand, with resilient private consumption, supported by the improvement in the labour market, and a clear recovery in investment, once capacity utilization reverts to long-term average. As a result, our forecasts point towards an increase in the contribution of domestic demand to economic growth in 2011. With regard to external sector, the dynamism of exports should be offset by a larger increase in imports, resulting in a negligible contribution to growth. Therefore, French economy could grow by around 2% in 2011, as the eurozone average, also decelerating in 2012 to around 1.5%.

The early stages of the upswing were supported by expansionary fiscal measures, although the fiscal consolidation plan should not weigh on the sustainability of the recovery. In particular, France's public finances face challenges ahead after a deficit at -7% of GDP in 2010 and with the objective of reaching the 3% by 2013. Although better than expected economic prospects this year will reduce the needed structural effort, on average the French economy will require an annual consolidation effort of 1.3 pp of GDP on average up to 2014. French debt stands at 82% of GDP and is rated at AAA, although some concerns are rising as the deficit reduction relies on optimistic growth assumptions and lacks clearly defined measures to cut spending.

Regarding price developments, inflation has been much more stable than in the eurozone average since mid-2010, partly because of the lesser weight of energy products in the harmonized consumer index, with an increase in inflation of 0.3pp from Q4 2010 compared to 0.8pp observed in the monetary union. Notwithstanding this, the timid acceleration in inflation observed in Q2 was mainly due to higher prices of core components, although it could partly be explained by a base effect on annual rates after the fall recorded in prices of non-fresh food a year ago. Overall, both headline and core inflation remained clearly below the eurozone average. The latter should be maintained for the rest of the year, according to our forecasts, with an average annual inflation rate around 2.3% in 2011 as a whole. Despite the recent strength of the recovery, second round effects are even less likely in France than in Germany, since the unemployment rate is higher despite of the improvement in the labor market. In addition, it must also be noted that a new framework for regulating the minimum wage was established that could end up moderating wage demands.

Italy: Sluggish export-led recovery continues, although more vulnerable

The Italian recovery is still much slower than the one in other large countries, which can be attributed to structural problems that Italy suffers. In particular, GDP has increased by a cumulated of 2% since the beginning of the upswing, far from the accumulated fall of about 6.5% during the crisis. More worryingly, its low potential growth implies that output will be below pre-crisis levels for quite some time.

The main concern referring Italy lies in the high ratio of public debt, that currently stands at 119% of GDP. However, household and corporate indebtness is low, the country has not experienced a housing bubble in recent years while its external deficit and net foreign debt are also low. Higher spreads triggered by persistent funding difficulties could raise the interest bill, but only very slowly. Overall, weak potential growth remains the main challenge for the future, but the absence of large imbalances beyond the high public deficit implies that the country does not face a risk of insolvency.

Earlier this year, economic growth was again anaemic, after having lost momentum in the second half of 2010. Available data for Q2 continue to suggest that the Italian economy has remained virtually stagnated. In particular, industrial data showed further evidence of dependence on exports for the sustainability of the recovery. The strength of world demand, on the other hand, and the recovery in Germany and France have led to an increase in investment. As a result, the labour market remains weak, which combined with uncertainty about economic prospects in coming quarters has negatively affected households' consumption. Overall, Italy's growth is expected to continue at a modest pace, even below its potential, supported by exports and investment. GDP should grow at around 0.8% in 2011 and 0.7% in 2012, as higher financial costs and additional fiscal consolidation could dampen the recovery next year. These figures mean that Italian economy would have caught up only half of the output loss accumulated over the downturn.

Underlying the slow recovery is that the economy was constrained by the lack of fiscal room, and thus the fiscal stimulus was very modest at the time that other EU countries were applying measures of up to 2% of GDP to stimulate demand in early 2009. Still, Italian fiscal figures have been under severe scrutiny in the last weeks of July after stress due to the Greek crisis spread to the rest of the periphery. Spreads in Italy have reached maximum levels and have forced the government to announce a fiscal consolidation package of €47bn so as to cut the budget deficit by 2014. The main drawback of the new plan is that measures are back loaded 2, 6, 17.8 and 25.3 bn eur rising concerns regarding their implementation, since most of the adjustment will have to take place after the next elections, to be held by mid-2013. Concrete details on the measures and quantitative impact have not been fully disclosed, measures include cuts to local governments and health expenditure and an increase in the retirement age.

Regarding price developments, as in other member states, the sharp acceleration in both headline and core inflation observed earlier this year has also interrupted in Q2, although both annual rates are above the eurozone's average. In particular, the moderation of energy prices in recent months did not offset completely the increase in core inflation, unlike what happened in other countries. However, it also should be noted that methodological changes introduced earlier this year for the treatment of prices of seasonal components has had significant effects on the evolution of inflation. For 2011 as a whole, we expect headline inflation to be around the monetary union's average (2.6%), while the slowdown expected for 2012 will be more moderate, averaging a rate of around 2%.

Spain: Slow recovery with increasing uncertainty on economic prospects

The growth pattern of the Spanish economy continues to be characterized by a clear duality between the sluggishness of domestic demand and the strength of net exports. After a GDP growth slightly higher than our expectations at the beginning of the year (0.3% q/q), the Spanish economy could have continued to show a timid expansion in activity in Q2, about 0.2% q/q, confirming the weakness of the recovery started in early 2010. As a result, both employment and labour force virtually stagnated, despite the positive seasonality, resulting in a marginal fall in the unemployment rate that still remain at very high levels (21.2%).

Looking forward, the growth pattern described above is expected to continue, with positive GDP growth rates, albeit with also increasing uncertainty about economic prospects in coming quarters. Some downside risks to the economic outlook (high oil prices and earlier interest rate hikes by the ECB) taken into account three months ago continue to evolve in line with our expectations with a modest impact on activity. Nevertheless, recent upturn in uncertainty about sovereign debt in the eurozone, as well as increasing doubts about the ability of some Spanish regions to meet their fiscal targets by year-end, together with the low ambitious reform of collective bargaining could end up adversely affecting domestic demand.

Overall, we expect the Spanish recovery pace to remain sluggish in the short to medium-term, resulting in an annual average growth of around 0.9% in 2011. As described in the last Spain

Economic Outlook, the economy should be able to generate jobs by the end-2011, although the decline in the unemployment rate will take place next year. For 2012, we revise slightly down our GDP growth forecast by 0.3pp to 1.3%, as a consequence of above additional negative factors. Despite this slight revision, we highlight that our economic assessment remains unchanged, with a current outlook nearly to stagnation and a gloomy outlook for coming quarters. Consequently, maintaining the reforms momentum must be priority in order to strengthen potential growth, as well as efforts to address the economic imbalances accumulated before and during the last downturn.

Regarding the evolution of prices, inflation slowed gradually in Q2, suggesting that the peak should be behind us. Headline inflation remains above the eurozone's average, reaching 3.2% at the end of the quarter. Nonetheless, just over half annual inflation rate continues to reflect the sharp rise in energy prices and unprocessed food, around 1.8pp, while the remaining 1.4pp are due to higher core inflation. As described in the previous Spain Economic Outlook, the high unemployment rate has prevented increases in real wages (-0.5% y/y in June on the wages of collective bargaining), despite the fact that high commodity prices ended up moving to consumer prices, directly through its final consumption and indirectly through its intermediate consumption. Overall, there is no clear evidence on second round effects. In addition, Q2 data also show no evidence of a significant loss of prices competitiveness. In fact, the headline inflation gap with the eurozone in June stood at 0.3pp, while the gap was negative (-0.2pp) if is gauged with core inflation. Underlying this gap are, basically, tax changes introduced in Spain in H2 2010. Overall, we expect that Spanish inflation should end up averaging around 3.0% in 2011, slowing significantly in 2011 to average a arte of around 1.4%, below the eurozone's average.

Box 3. Portugal: the sharp adjustment will bring a recession, but structural reforms should lift growth potential

Three months after the request of financial aid that took place in April and resulted in a 78 bn eur loan, Portugal is proceeding by implementing the measures to comply with the IMF/EU conditionality program. After the elections that took place on June 5th, a centre-right coalition government was formed between the PSD and CDS, which enjoys a sufficient majority in Parliament. The new Prime Minister Passos Coelho has reiterated its commitment with the IMF-EU programme and even announced its intention to be more ambitious than the plan in its fiscal plans.

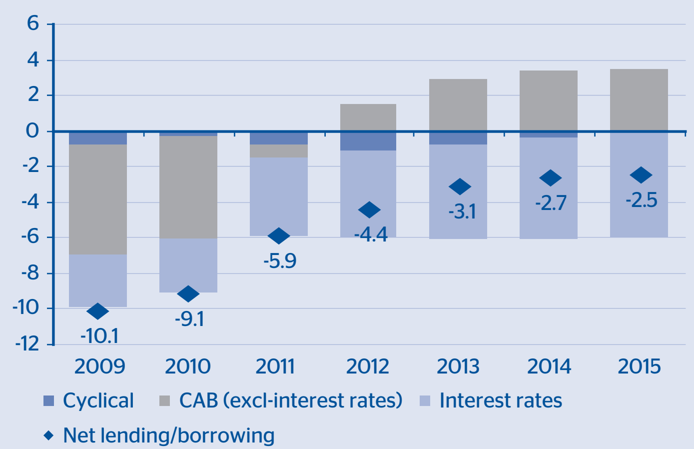
Despite this progress, the credit agency Moody's cut the rating of Portugal in early July by four notches to Ba2 (to junk bond). The credit agency argued that the probability that Portugal will need a second aid package, followed by the involvement of the private sector, was high. It also considered that there was an implementation risk in the reforms that Portugal had to implement, and there was a chance that their effects on higher growth would only be noticed in the long term. The downgrade, however, is not justified by fundamentals and seems more determined by the uncertainty linked to the Greek crisis and the lack of decisiveness by EU authorities.

Additional measures to reduce the government debt burden are being taken

Under the IMF programme and on the fiscal front the plan targets a 3% deficit by 2013, instead of a previous target set at 2012. It includes an important tax reform to make the system less distortive and favouring competitiveness. Under the programme, discretionary fiscal measures amount for 10.6% of GDP for the 2011-13 period, tilted towards expenditure cuts (7.2pp). According to our estimates, these measures are above the required effort to achieve the target, which provides a buffer for unexpected slippages or additional financing requirements. This is partly explained by our view on economic activity that is less pessimistic than the one from the Government and the IMF, which leads to a smaller cyclical deterioration. With regard the interest rate bill our projections are very much in line with the IMF. The government announced by mid July an additional saving measure that include an special Christmas tax that is expected to raise t 1.025 bn eur (840 million this year) and further privatizations, apart from the already agreed privatization of enterprises with the troika in the sector of transport, energy, communications, financials as well as small firms. The Government announced in July that it will privatize Águas de Portugal (in total the privatization programme is expected to raise more than 5.5 bn eur). With regard the timing it is expected that major sales of stakes of EDP and REN together with the sale of TAP will take place before this year end, and to identify by March 2012 further susceptible enterprises to be sold.

Public debt stood at 93% of GDP in 2010 and, according to IMF estimates, it will reach a maximum in 2013 of 115.3%. The up-ward revision in debt up to 22 pp of GDP, partly explained by the primary balance effect and automatic debt dynamics (i.e. from the interest rate growth differential) and the rest from the recognition of implicit or contingent liabilities and bank recapitalization total: 17.3 pp of GDP up to 2014. Privatizations valued at 3.5 pp of GDP will imply the opposite effect.

Chart 21
Portugal, deficit



Source: Eurostat and BBVA Research

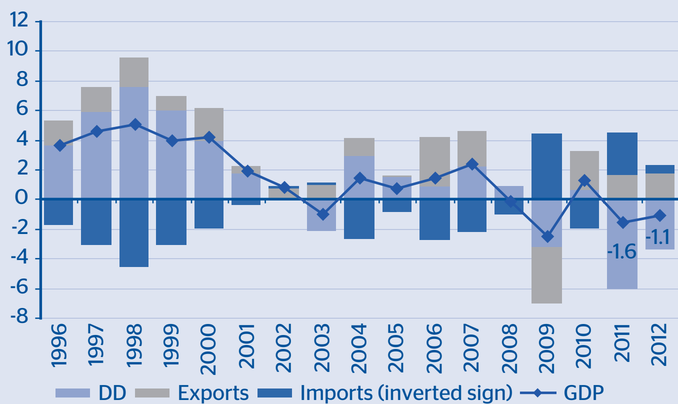
Activity will fall in 2011 and 2012

In view of the additional fiscal consolidation measures we have revised downwards our projections for the Portuguese economy. Domestic demand will decline more than initially expected, as deleveraging process and high levels of unemployment will affect private consumption. The fiscal consolidation retrenchment will impact public consumption and public investment, and indirectly private consumption. Consumer confidence is at minimum levels and business climate is falling. Exports will remain the key growth driver; it is expected to grow by 5.2% and net exports to contribute positively by 4.5 pp this year. At the same time will indirectly counteract the negative impact on private investment, were we expect a decline of -7.3%, slightly less negative than other projections made by international institutions.

Our forecasts point to a GDP contraction of -1.6% in 2011 and -1.1% in 2012, with a sharp drop in both consumption and investment. Our view of activity in Portugal is of a recession, but our outlook is less negative than the government as the fiscal adjustment is not as extreme as it has been for Greece, foreign demand will provide some support and some structural reforms should help to recover positive growth rates relatively soon. Prices are expected to increase on average in 2011 up to 3.4% mainly due to VAT increases and energy prices, however excluding taxes the rate of inflation stands by 1.5 pp below. From a medium-term perspective,

structural reforms agreed under the aid package will have direct effects on potential GDP growth, as it covers all the areas of weakness: labour market reform, privatisation, public sector reform, and further reforms in education, judiciary system, telecoms and electricity. The labour market reform is progressing smoothly and in line with the calendar established in the Memorandum of Understanding the bill that affects the unemployment insurance scheme has been approved by mid July. The severance payment was reduced from 30 days to 20. This measure will affect new contracts and the aim is to reduce labour market segmentation and fostering job creation. The reform agenda marked for the second semester is very ambitious and by the end of the year we expect further steps in the duration of unemployment benefits, definition of dismissals and working time arrangements, the latter so as to contain employment fluctuations and enhance firms competitiveness.

Chart 22
Portugal, GDP growth and contributions



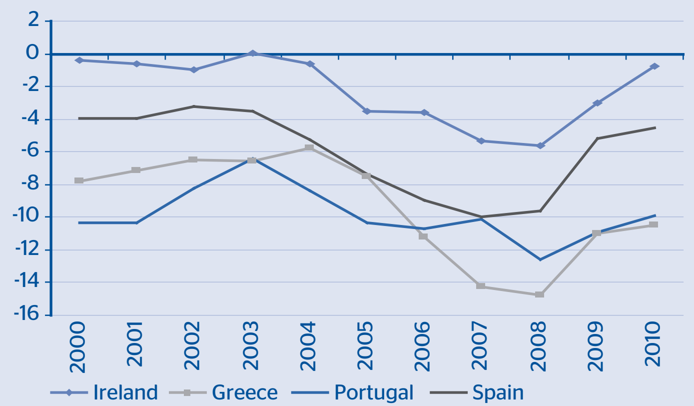
Source: INE and BBVA Research

External financing needs and disorderly deleveraging as potential risks

The Portuguese economy suffers of several imbalances that need to be corrected in an orderly manner in the years to come. First, a high current account deficit that currently stands at -9.9% of GDP in 2010 and, contrary to other economies, has barely corrected over the crisis. This reflects a high dependency of external financing explained by low savings rate. To close the gap it will be required an important increase in domestic saving, with its consequent impact on consumption that should reduce imports.

The second source of concern, and closely related to the first one, is the high level of indebtness of the private sector, that excluding the financial sector stands at 253% of GDP. Both corporate financial indebtness at 148% of GDP and household debt at 105% of GDP rank among the highest in the euro area. This implies a source of vulnerability first due to the possible impact could have the lack of credit from the financial sector and the high dependency of external financing as 60% of the Portuguese debt is in foreign hands.

Chart 23
Current Account deficit % of GDP



Source: AMECO and BBVA Research

The Portuguese banking sector passes the exam

The EU-IMF financing programme 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, sets reduced target leverage ratios and increases minimum solvency ratios (to 9% and 10% in 2011 and 2012, respectively). Banks have already delivered their recapitalisation plans to the Bank of Portugal and we think that they will be able to comply with the new requirements without using the public aid available in the rescue. According to the objectives of these plans, a significant part of this recapitalization process will take the form of a fall in risk weighted assets.

With regard to the recently published stress tests, none of the four Portuguese banks that were subject to the exercise have failed. Although the tests have been more realistic than last year's we think that the limited stress applied to the sovereign bond portfolios held by some Portuguese banks limits the credibility of the stress tests. Therefore the expected losses look slightly optimistic for some of the institutions. We think that this might be one of the weakest points to highlight in the case of Portuguese banks

Related to operating profits, we see as realistic the assumptions provided for BES and BCP, while we are more doubtful in the case of BPI. Under the adverse scenario, BPI's operating profit before impairments is in line with our estimates (which are not stressed); while for BCP and BES operating profit forecasts in the adverse scenario stand below our estimates.

Concerning sovereign exposure, Portuguese banks have on average 2.36x their core equity in peripheral sovereign bonds. We underline that BPI's sovereign bonds represent 3.36x its core equity, thus a stress of the banking book should have had a significant impact on the bank's capital ratios.

3. Tables

Table 1

Summary of forecasts

Euro Area (YoY growth rate)	2008	2009	2010	2011	2012
GDP at constant prices	0.3	-4.1	1.7	2.0	1.3
Private consumption	0.3	-1.2	0.8	1.2	1.3
Public consumption	2.2	2.4	0.3	0.6	0.1
Gross Fixed Capital Formation	-1.1	-11.7	-1.0	3.3	2.7
Inventories (*)	-0.2	-0.6	0.6	0.1	0.0
Domestic Demand (*)	0.2	-3.3	0.9	1.5	1.2
Exports (goods and services)	0.7	-13.1	11.1	6.4	3.2
Imports (goods and services)	0.6	-11.8	9.3	5.6	3.2
External Demand (*)	0.0	-0.8	0.8	0.5	0.1
Prices and Costs					
CPI	3.3	0.3	1.6	2.7	1.8
CPI Core	2.4	1.3	1.0	1.7	1.9
Labour Market					
Employment	0.9	-1.8	-0.4	0.5	0.7
Unemployment rate (% of labour force)	7.7	9.6	10.2	9.8	9.5
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-2.0	-6.3	-6.0	-4.3	-3.4
External Sector					
Current Account Balance (% GDP)	-0.9	-0.6	-0.4	-0.2	-0.1

Source: Eurostat and BBVA Research

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2008	2009	2010	2011	2012
United States	-0.3	-3.5	3.0	2.1	2.6
EMU	0.3	-4.1	1.7	2.0	1.3
UK	-0.1	-4.9	3.4	1.3	1.6
Latin America *	5.2	-0.6	6.6	4.8	4.4
Mexico	1.5	-6.1	5.4	4.1	3.8
EAGLES **	6.6	4.0	8.3	7.0	6.9
Turkey	0.7	-4.7	8.2	6.3	4.2
Asia Pacific	5.2	4.1	8.0	6.2	6.7
China	9.6	9.2	10.3	9.4	9.1
Asia (exc. China)	2.3	0.8	6.5	4.1	5.2
World	2.8	-0.7	5.0	4.2	4.4

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2008	2009	2010	2011	2012
United States	3.8	-0.3	1.6	2.8	2.2
EMU	3.3	0.3	1.7	2.7	1.8
UK	3.6	2.2	3.3	4.3	2.3
Latin America *	8.8	6.9	7.4	8.2	7.9
Mexico	5.1	5.3	4.2	3.4	3.8
EAGLES **	7.4	2.9	4.5	6.1	5.0
Turkey	10.4	6.3	8.6	6.5	6.0
Asia Pacific	5.7	0.3	2.7	4.8	3.6
China	6.0	-0.8	1.2	5.3	3.9
Asia (exc. China)	5.5	1.1	3.7	4.5	3.5
World	6.1	2.2	3.0	4.8	4.1

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Current Account (% GDP)

	2008	2009	2010	2011	2012
United States	-4.6	-2.7	-3.3	-3.4	-3.8
EMU	-0.5	-0.5	-0.5	-0.2	-0.1
UK	-1.6	-1.7	-2.5	-1.2	-0.1
Latin America *	-0.7	-0.3	-0.8	-0.7	-1.7
Mexico	-1.6	-0.7	-0.5	-0.8	-1.1
EAGLES **	4.0	2.3	1.9	1.5	1.4
Turkey	-5.6	-2.2	-6.4	-10.8	-9.1
Asia Pacific	4.8	3.8	3.2	2.7	2.9
China	9.9	6.1	5.2	4.5	4.5
Asia (exc. China)	1.4	2.3	1.9	1.6	1.8

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Government Deficit (% GDP)

	2008	2009	2010	2011	2012
United States	-3.2	-10.0	-8.9	-9.5	-6.9
EMU	-2.0	-6.3	-6.0	-4.3	-3.4
UK	-5.0	-11.4	-10.4	-8.8	-7.2
Latin America *	-1.1	-2.8	-2.0	-2.3	-2.7
Mexico	-0.4	-0.7	-0.8	-0.8	-2.7
EAGLES **	-1.8	-5.3	-2.9	-2.9	-2.8
Turkey	-1.8	-5.5	-3.7	-9.0	-8.5
Asia Pacific	-2.8	-5.1	-3.8	-4.2	-3.5
China	-0.4	-2.2	-2.5	-2.0	-1.8
Asia (exc. China)	-4.4	-6.5	-4.7	-5.7	-4.7

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 6

Financial Variables

Official Interest Rates (End period)	2008	2009	2010	2011	2012
United States	0.61	0.25	0.25	0.25	1.25
EMU	2.73	1.00	1.00	1.75	2.00
China	5.31	5.31	5.81	6.81	7.31
10-year Interest Rates (Avg.)					
United States	3.6	3.2	3.2	3.3	4.0
EMU	4.0	3.3	2.8	3.2	3.5
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.68	0.72	0.76	0.71	0.75
EMU	1.47	1.39	1.33	1.40	1.34
UK	1.82	1.56	1.55	1.63	1.66
China	6.95	6.83	6.77	6.46	6.15

Forecast closing date:August 1, 2011
Source: BBVA Research

Table 7
Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	0.6	-0.1	0.4	1.4	1.2
Public consumption	2.3	2.9	1.9	1.3	0.7
Gross Fixed Capital Formation	1.8	-10.0	5.7	8.7	5.2
Inventories (*)	-0.2	0.1	0.6	0.0	0.0
Domestic Demand (*)	**0.9**	**-1.5**	**2.3**	**2.7**	**1.8**
Export	2.0	-14.3	14.4	7.9	5.9
Import	2.9	-9.4	12.8	7.4	6.7
Net export (*)	**-0.2**	**-3.2**	**1.2**	**0.6**	**0.0**
GDP	**0.7**	**-4.7**	**3.5**	**3.3**	**1.8**
Inflation	**2.8**	**0.2**	**1.2**	**2.6**	**1.8**

(*) Contribution to growth
Source: BBVA Research

Table 8
France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	0.2	0.2	1.6	1.6	1.5
Public consumption	1.2	2.3	1.4	0.7	0.3
Gross Fixed Capital Formation	0.1	-8.8	-1.6	3.9	3.3
Inventories (*)	5.0	-1.4	0.1	0.1	0.0
Domestic Demand (*)	**0.1**	**-2.4**	**1.0**	**1.9**	**1.5**
Export	-0.6	-12.2	9.9	6.1	6.0
Import	0.6	-10.6	8.3	6.0	5.7
Net export (*)	**-0.4**	**-0.3**	**0.4**	**-0.1**	**0.0**
GDP	**-0.2**	**-2.6**	**1.4**	**1.9**	**1.5**
Inflation	**3.2**	**0.1**	**1.7**	**2.3**	**1.6**

(*) Contribution to growth
Source: BBVA Research

Table 9
Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	-0.8	-1.8	1.0	0.7	0.8
Public consumption	0.5	1.0	-0.6	-0.2	0.0
Gross Fixed Capital Formation	-3.8	-12.0	2.3	1.6	1.7
Inventories (*)	-0.2	-0.7	0.8	0.0	0.0
Domestic Demand (*)	**-1.4**	**-4.0**	**1.8**	**0.7**	**0.7**
Export	-4.4	-18.4	8.9	5.1	4.7
Import	-4.4	-13.8	10.3	4.2	4.4
Net export (*)	**0.0**	**-1.2**	**-0.5**	**0.2**	**0.0**
GDP	**-1.3**	**-5.2**	**1.2**	**0.8**	**0.7**
Inflation	**3.5**	**0.8**	**1.6**	**2.6**	**2.0**

(*) Contribution to growth
Source: BBVA Research

Table 10

Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	1.3	-1.1	2.3	-3.9	-2.8
Public consumption	0.4	3.6	1.2	-7.9	-3.3
Gross Fixed Capital Formation	-0.3	-11.3	-4.9	-7.3	-4.8
Inventories (*)	0.0	-0.6	-0.1	-0.3	0.0
Domestic Demand (*)	**0.9**	**-3.2**	**0.7**	**-6.1**	**-3.4**
Export	-0.1	-11.6	8.8	5.2	5.1
Import	2.3	-10.6	5.1	-7.2	-1.5
Net export (*)	**-1.0**	**0.7**	**0.6**	**4.5**	**2.3**
GDP	**-0.1**	**-2.5**	**1.3**	**-1.6**	**-1.1**
Inflation	**2.7**	**-0.9**	**1.4**	**3.4**	**1.6**

(*) Contribution to growth
Source: BBVA Research

Table 11

Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012
Private consumption	-0.6	-4.3	1.3	0.3	0.6
Public consumption	5.8	3.2	-0.7	-0.2	-1.3
Gross Fixed Capital Formation	-4.8	-16.0	-7.5	-4.9	-0.4
Equipment and other products	-3.0	-21.2	-2.1	0.6	3.0
Construction	-5.9	-11.9	-11.1	-9.1	-2.9
Housing	-10.7	-24.5	-16.5	-7.5	0.9
Other construction	-0.8	-0.1	-7.2	-10.0	-5.2
Inventories (*)	0.1	0.0	0.1	0.0	0.0
Domestic Demand (*)	**-0.6**	**-6.4**	**-1.1**	**-1.0**	**0.0**
Export	-1.1	-11.6	10.3	11.0	6.0
Import	-5.3	-17.8	5.5	3.7	1.0
Net export (*)	**1.5**	**2.7**	**1.0**	**1.8**	**1.3**
GDP	**0.9**	**-3.7**	**-0.1**	**0.9**	**1.3**
Inflation	**4.1**	**-0.3**	**1.8**	**3.0**	**1.4**

(*) Contribution to growth
Source: BBVA Research

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