Economic Outlook

Europe

Second Quarter 2013
Economic Analysis

- **Risk events in Europe during the first quarter of the year, linked to Cyprus and Italy, have barely affected financial conditions.**
- **However, the economic recovery is delayed,** with some weakness in the core economies of the eurozone.
- **Further ECB's support,** less restrictive fiscal policies and global demand will result in a gradual recovery throughout 2H2013.
- **The banking union, correcting structural imbalances and commitment with reforms** are key factors to overcome the crisis.

Index

Closing date: May 7, 2013

1. Editorial

In recent months Europe has proved highly resilient in dealing with two risk events (political uncertainty in Italy and the botched attempt to bail out Cyprus), but at the same time the eurozone economy has clearly been struggling to emerge from recession.

The Cyprus bailout and the difficulties forming a stable government in Italy have had a very limited and short-lived impact on the sovereign debt markets and the euro. In Cyprus, the initial mismanagement of the crisis by the European and Cypriot authorities again demonstrated that there is clear scope for improvement in the handling of problems and that financial contagion could return if inappropriate decisions are taken. In Italy forming a government has proved tricky following the elections in mid February and doubts surround the medium-term stability of the coalition cabinet named. Nonetheless, the debt market reaction was moderate even though it is uncertain whether the policies of the new government will succeed in steadily reducing the public deficit in the short and mid term. A reason for caution is the ratcheting up of tension in bank financing, which is affected by the doubts generated by the bailout of Cyprus which entails the involvement of private creditors, including uncovered deposits, given the absence of other debt instruments between deposits and capital.

In the real economy there are still signs of weakness. The gradual economic recovery forecast in the eurozone from the first quarter of the year, driven by exports to the rest of the world and spearheaded by Germany, has failed to materialise. First-quarter growth was zero or just above but confidence indicators fell again between February and April and this suggests that emerging from recession will take longer than forecast. And what's more, the weakness that was previously only noted in peripheral countries has also spread to the core economies in the eurozone, with negative indicators in France and some weakness of late even in Germany, which to some extent has been dragged down by the rest of Europe.

Even so, the fundamentals for recovery are still in place: as well as relatively robust growth in the rest of the world (we estimate global growth of 3.3% in 2013 and of 3.9% in 2014), the improved financial conditions, in particular for sovereigns, since the announcement of the OMT programme by the ECB should have a gradual impact on the real economy. The tone of economic policies should also help recovery. Although fiscal policy will remain tight, especially in the periphery countries, the criteria for deficit reduction are easing with no additional adjustments to mitigate cyclical slips behind deficit reduction targets, as we have repeatedly supported it here. Moreover, there has been a clear shift in the tone of monetary policy. At its meeting at the start of May, the ECB not only cut its policy rate but also signalled its willingness to adopt additional measures including further rate cuts and support measures to revive bank lending, in particular for SMEs. Although these measures alone are unlikely to suffice to solve the peripheral countries' financing problems, they do send out an important message that monetary policy will be eased for as long as necessary. Accordingly, we expect growth in the eurozone to contract by -0.1% this year and to increase by 1% in 2014, with Germany posting stronger growth than the rest of the zone and the periphery remaining clearly in recession through the first six months of the year despite steady improvement in the second half.

The strategy for exiting the crisis is still based on the ongoing support of the ECB, which gives the troubled eurozone countries time to continue gaining credibility by adjusting their public accounts while Europe presses ahead unhindered with the integration process. Here the focus has switched from eventual fiscal union, championed until mid 2012, to the need to complete a functional banking union in line with the programme set out at last December's summit. This strategy is essential to ease fragmentation of bank financing markets, which remains very high, and to reduce the sovereign-bank link which is incompatible with a monetary union. Furthermore, this process should help to revive lending to the private sector where creditworthy demand exists. It is therefore important that the decisions taken in mid 2013 regarding common supervision and, in particular, the common resolution framework satisfy the expectations raised in December and clearly point the way towards greater integration.

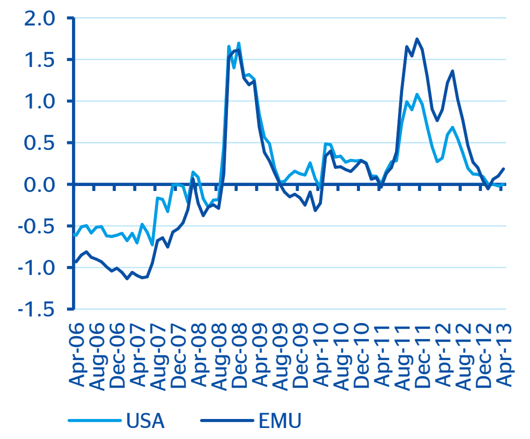
2. Growing divergences in the global economy

Over the last three months some of the threats to global economic recovery have receded, but there is now growing divergence between the different areas

There is growing disparity between the economic performance of the US and the eurozone, where weakness has reached the core economies. In addition, despite doubts about the long-term sustainability of growth in China (or even the final growth in 2013), the country does not appear to be headed towards a sharp adjustment in the short term. There is some disappointment in the rest of the emerging Asian economies when compared with earlier growth expectations, though these were probably too high. Japan is on the crest of a wave of economic optimism, although so far this has only manifested itself in the valuations of some financial assets and indicators of confidence, rather than indicators of the real economy.

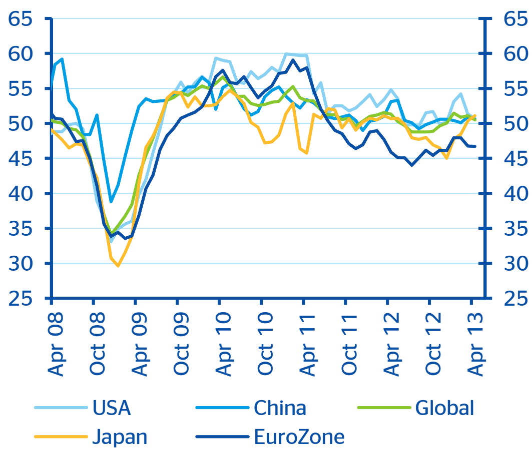
There has only been a limited response in the financial markets to events such as the continued uncertainty regarding the definition of long-term fiscal policy in the US, the internal political paralysis in Italy and the events in Cyprus and Portugal (see Chart 1). Thus risk premiums have fallen in the eurozone, largely due to the implicit support from the ECB's OMT programme and the abundant global liquidity, which is benefiting the dash for return and the ensuing financial risk-on mood at the global level. Nearly all assets are benefiting from this change in perception, with practically only one exception: the upturn in the credit risk indicators of the eurozone's banking sector.

Chart 1
BBVA Financial Tension Indicator



Source: BBVA Research

Chart 2
Confidence Indicators (PMI)

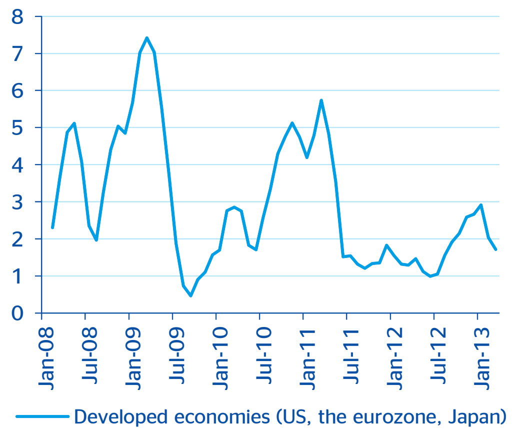


Source: Markit and BBVA Research

The most recent economic indicators reflect the divergence between areas. In all, the trend towards stability in global manufacturing confidence has been maintained, although with growing divergence between regions (see Chart 2 and Chart 3). In any event, the positive tone in the financial markets and divergence in cyclical prospects have not yet led to any significant change in activity or trade at a global level. According to our global BBVA-GAIN1 activity indicator, even the most recent data confirm our expectations of continuing global GDP growth at a quarterly 0.7% (see Chart 4). However, more varying prospects between the main economies (in particular due to the downward revision in GDP growth in the eurozone and also in some economies in

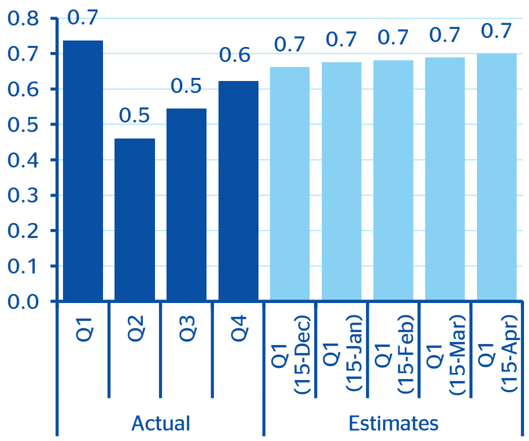
1: For more details, see BBVA Research's Economic Outlook published on 6 March, 2013: http://www.bbvaresearch.com/KETD/fbin/mult/130306_EcWatch_BBVAGAIN_tcm348-379375.pdf?ts=2942013 emerging Asia) have put a brake on the strength of the recovery expected in 2013 and 2014. As a result, we have revised down our growth forecasts for the world economy to 3.3% in 2013 and 3.9% in 2014, from 3.6% and 4.1% respectively.

Chart 3
Developed economies: standard dev. PMI (US, eurozone and Japan)



Source: Markit and BBVA Research

Chart 4
Global growth based on BBVA-GAIN (% q/q)



Source: BBVA Research

What lies behind the sustained growth in the US, despite fiscal uncertainty? Strong private consumption and continued monetary expansion

Although GDP growth figures in the first quarter of 2013 were below market expectations, they confirmed the continued healthy tone shown so far by private consumption. This is due to an improvement in job creation, in terms of jobs and wages, and the financial situation of households (wealth effect). Private spending has become a support for growth in the US. Furthermore, American financial markets have not been affected by external contagion from risk events such as those from the euro area. However, the most recent indicators of cyclical prospects (manufacturing expectations), have fallen in March and April to levels compatible with a slump of activity, so we expect an additional slowdown of the GDP in the second quarter[2].

In all, we maintain our forecasts for the US economy in 2013 and 2014 without major changes, with rates of growth at 1.8% and 2.3%, respectively, mainly for two reasons. First, despite the uncertainty regarding the fiscal cliff and the entry into force of the sequester (automatic public spending cuts), private spending has given clear signs of resilience. Second, since inflation expectations are fairly anchored, quantitative easing (QE) may continue without problems until there is significant improvement in labour market prospects. Although some of the data at the start of the year could have prompted an early withdrawal of stimuli, the most recent information shows that the American economy is still far from sufficiently robust growth rates, so monetary policy will continue to be a support for growth.

In Asia, doubts linger about the strength of the Chinese growth; optimism in Japan on the back of its massive quantitative expansion

The Chinese economy has lost some of its strength in the first quarter of 2012, when investment was weak, despite increased external demand and while growth remains in line with the

2: For further details see our US Economic Watch, available at
http://www.bbvaresearch.com/KETD/fbin/mult/130401_EconomicWatchEEUU_194_tcm348-381612.pdf?ts=352013

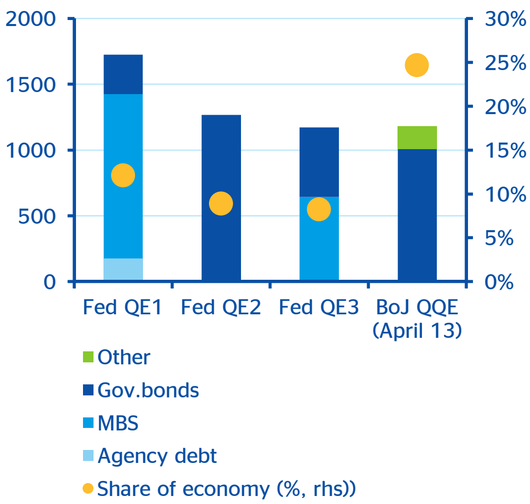
government target of 7.5% for 2013. The measures implemented to tackle the financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a more consumption-oriented economy continues. With inflation also lower than expected, pressure for tighter monetary conditions has eased. As a result, the authorities have room for manoeuvre, given their commitment to sustainable growth. In all, our forecast for growth in China remains unaltered at 8% for 2013 and 2014.

In contrast, the Japanese economy will benefit from a package of more aggressive than expected policies. Among them is the massive quantitative easing, whose size amounts to around 25% of Japan's GDP (each of the QE implemented by the Fed represented an average of 10% of America's GDP), aimed at changes in inflation expectations and boosting growth (see Chart 5). This monetary boost will be more effective if it is accompanied by effective fiscal measures and, in particular, structural reforms. Thus our growth forecast for the Japanese economy for 2013 and 2014 remains at 1.7%, above the 1.3% consensus.

In any event, it is difficult to quantify the impact of this new move and know how investors will react, given that many uncertainties still exist. For example, if this policy is successful in promoting growth and confidence at a national level, it could generate greater net capital inflows globally (instead of outflows). In addition, its impact at a domestic level in Japan is also uncertain, as the Bank of Japan's policy involves some risks: strong volatility in sovereign bonds (JGB), risks for bank's balance sheets and the costs of debt for the government when nominal yields grow, provided the Bank of Japan is successful in complying with its inflation target of 2%.

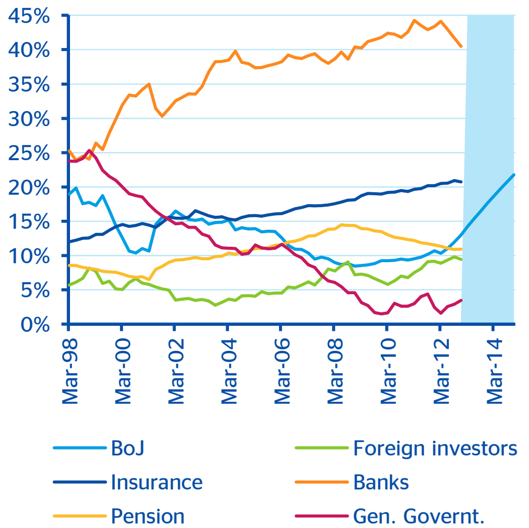
However, the new monetary facility provides arguments in favour of Japanese investors investing increasingly abroad. The Bank of Japan's demand will push private Japanese investors away from domestic assets, as the central bank plans to buy around 70% of all the new issuance of sovereign bonds. As a result, the Japanese government's share of bonds in 2014 will be over 20% (see Chart 6). The movement of funds will therefore also be uncertain. The appetite of Japanese investors for US bonds has increased since the start of the eurozone crisis, but they also returned to the European stock markets last year. In particular, they invested in countries at the core of the eurozone, such as France, the Netherlands and Germany, while limiting sales in peripheral securities. This trend with respect to peripherals has recently shifted. In this context, we expect demand for assets in euros to increase, provided that the euro-convertibility risk does not emerge again.

Chart 5
Successive rounds of QE (USD bn), Fed and BOJ



Source: Haver and BBVA Research

Chart 6
JGB holders since 1998 (%)



* (Including T-bills and FILP bonds) Government sector includes fiscal loan fund while excluding public pension funds which is included in pensions.
Source: Haver and BBVA Research

Monetary easing in developed economies favours risk taking, pushes long-term rates down and the appreciation of emerging market currencies

Financial markets are still dominated by flows from central banks, inflation below targets in the eurozone, the U.S. and Japan, a neutral balance of risks to growth in the U.S., downward bias in the eurozone and by pending improvements in real indicators mirroring improvements in confidence indicators.

Against that backdrop, long-term rates on US and German bonds have gone down in recent months. The ensuing dash for yield in a less risk averse environment (partly because of the ECB actions) has also prompt a sharp fall in yields on government bonds in the periphery of Europe to levels not seen since 2010. In this context, there have been capital inflows to emerging fixed-income markets, especially the most liquid (Turkey, Brazil, Mexico), anticipating capital outflows from Japan after its QE program was announced, which includes purchases of public debt by the central bank of Japan.

As a result, the euro has shown great resilience to cyclical weakness in the area. The lower probability of high-risk scenarios and a monetary policy less accommodative vis-à-vis other central banks have helped the euro strengthen. In the absence of major risk events in Europe and as long as no surprises in the QE exit strategy by the Fed occurs, the euro could continue trading in its current range of 1.30 to 1.32 dollar per euro until the end of this year. This does not rule out episodes of dollar appreciation as a result of changes in the cyclical-risk balance and different central banks reactions.

3. The recovery in Europe, waiting for the advances towards a banking union

Europe has avoided the potential risk scenarios arising from the crisis in Cyprus, Italy and Portugal

Two of the risk factors that we envisaged in the previous issue have materialised, to some extent, in the last few months. On one hand, the Cyprus bailout was more complicated than expected since the private sector had a greater participation than that envisaged. Until Cyprus, the bank bailouts fostered by the troika had affected only the bank shareholders, and not the bondholders or depositors. In Cyprus, the model changed since it also affected large depositors. The crisis was also clearly managed sub-optimally since the first group of measures were going to include the bail-in of small depositors, but this was rejected by the Cypriot parliament and was finally replaced with a satisfactory solution. In any case, the statements made by some European authorities saying that this could be the model for future bank bailouts, which were partly denied afterwards, revived market doubts in such a way that bank debt spreads began stretching. Nevertheless, the Cyprus bailout has not affected the sovereign debt spreads of other countries, which contrasts heavily with previous crises in the periphery, which did have a strong impact on those markets.

In Italy, the long time period between the elections and the new coalition government formed by the two large political blocs, with doubts about the possibility of repeating the elections in the meantime, has not had a major impact on the sovereign debt of either Italy or other peripheral countries. This is due partly to the fact that this year's budget was already approved and Italy's 2012 deficit (3% of GDP) was relatively low, despite its high public debt ratio (around 130% of GDP). The government that has finally been formed has not yet revealed the details about its economic programme, apart from proposing a slower fiscal adjustment and announcing the abolition of some fiscal adjustment measures that had to be applied this year (elimination of the VAT rise from 21% to 22% in July and of the property wealth tax on first homes), which will have to be replaced by others. The political stability of the coalition government in the medium and long term does not seem to be certain.

In Portugal, the Constitutional Court struck down some of the fiscal consolidation measures included in the 2013 budget for reasons of inequity: specifically, the salary reduction for civil servants and pensioners by eliminating the extra pay. The impact of the measures is 0.8% of GDP, which is not too high, but the news, linked to a noticeable reform weariness, has temporarily generated doubts about the feasibility of the Portuguese government returning to the markets at the end of this year as expected. The government has approved alternative cost-cutting measures in different areas and, more recently, it issued long-term bonds, which were warmly received by the market. This, together with the rescheduling of the debt with the ESM and IMF, which was recently decided by Ecofin (pending the troika's confirmation), means that the Portuguese government's return to the markets is now much more feasible.

The financial conditions continued to improve in the euro zone in the first months of this year…

The sovereign debt markets of the peripheral countries have been positive in general. The events that took place in the last few months could have led to major tension in the markets, as in previous episodes. Even though the Cyprus bailout and the political instability in Italy have generated some volatility, its size and duration have been limited. Moreover, unlike previous episodes, the contagion to other peripheral countries has been more moderate. Therefore, the risk spreads in the peripheral countries (Chart 7), including those bailed out, have been somewhat volatile in the downward trend that began with Draghi's statements in summer 2012 and the subsequent announcement of the OMT programme. The lower risk perception of the peripheral countries has also been confirmed with the entry of foreign investors in the capital portfolios, which is helping to reduce the banks' dependence on ECB financing.

On the other hand, the interest rates of the European core countries' debt have remained lower than expected as a result of the deterioration of the growth expectations in Europe, a laxer and prolonged monetary policy, and considerable global liquidity. The mass monetary expansion announced by the Bank of Japan in early April has generated a widespread downward pressure on bond yields at a global level, and Europe, in general, and the peripheral countries, in particular, have not been an exception. The peripheral countries have probably benefited from this greater global appetite for risk.

This provides mixed factors for the overall European financial system. The liquidity situation has been favourable, as confirmed by the data regarding the banks' considerable repayment of the two 3-year LTROs. In a situation where there is less risk and in a year which has started with strong market issuances, the European banks have decided to reduce the cash cushion that they used over a year ago, in many cases as a precaution. However, the situation is not as positive in two other areas. Firstly, the market fragmentation, although it is moderating, continues to be high (Chart 8). And secondly, after the Cyprus bailout (including the bail-in formula), some deterioration can be seen in the banking credit risk.

Lastly, in the currency markets, the euro has remained quite strong against the dollar, despite the cyclical weakness and the aforementioned events. Regarding the exchange rate performance, the central banks' strategies (particularly their balance sheet management) are taking a leading role. In this sense, while the main central banks' balance sheets are expanding, the ECB's is decreasing (Chart 9). There is growing concern about the impact of the monetary expansion on the exchange rates; proof of this are the recent communiqués by the G7 and G20 after the Bank of Japan's announcement that explicitly state that no exchange rate target will be established and no competitive devaluations will be made.

… but the recovery will depend on the intensity of the banking union …

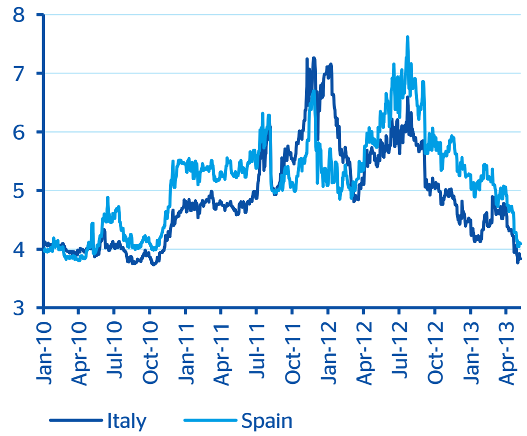
Despite the positive trend in the financial markets, the ECB's support and the world economy's growth, the recovery in the euro zone, mainly in the peripheral countries, is being dragged down in the short and medium term due to two factors. The first one is the fragmentation of the financial markets in the euro zone (Chart 8), which has led to higher effective interest rates in the peripheral areas than in the core countries (Chart 17) and a lack of credit availability in certain sectors and countries. To mitigate this problem, the ECB is not only providing liquidity to the banking system, reducing rates and using the OMT for the sovereign debt markets, it is also studying the measures on how to reactivate credit for small and medium enterprises (Box 1).

In addition to this support, the European strategy is based on specific steps towards a banking union, with a schedule established at the summit of the heads of state and government in December 2012, which envisages that the first step will be to implement a single banking supervision in 2013 throughout the euro zone, led by the ECB, which is already under way. A second step, which will be the key, is a mechanism to resolve the common banking crisis in Europe, which is currently being discussed and which should be approved in mid-year, and will probably be implemented at the start of 2014. Reaching a satisfactory agreement on this second issue will be the key to enabling the markets to disassociate the banking risk from the sovereign risk, helping the financing flows to return to the periphery without distortions and enabling the monetary transmission mechanism to be reactivated within the euro zone. The third step for the banking union (a common deposit guarantee fund) will be implemented later on.

… and on continuing the fiscal adjustment at the right pace

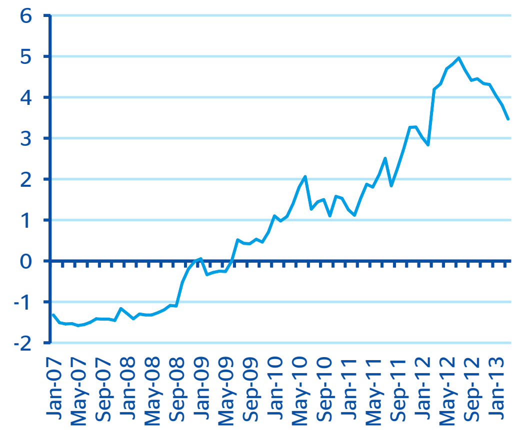
The second factor that is restraining the recovery is the need to reduce the public deficit of the peripheral countries with high deficit and/or debt levels. The fiscal adjustment expected in the euro zone remains (around 0.6% of GDP), less than in 2012 (1.3% of GDP), since the fiscal objectives have been relaxed, thus enabling the member states (mainly Spain and France) to meet these new goals without increasing the fiscal effort to compensate the greater cyclical deterioration of the public accounts caused by the worsening growth expectations (Box 2). Nevertheless, we cannot rule out the announcement of further adjustments in the peripheral countries to cover certain deviations, such as in Portugal, or less austerity, as in Italy.

Chart 7
Government bond spreads (basic points) (10yr with respect to Germany's bond yield)



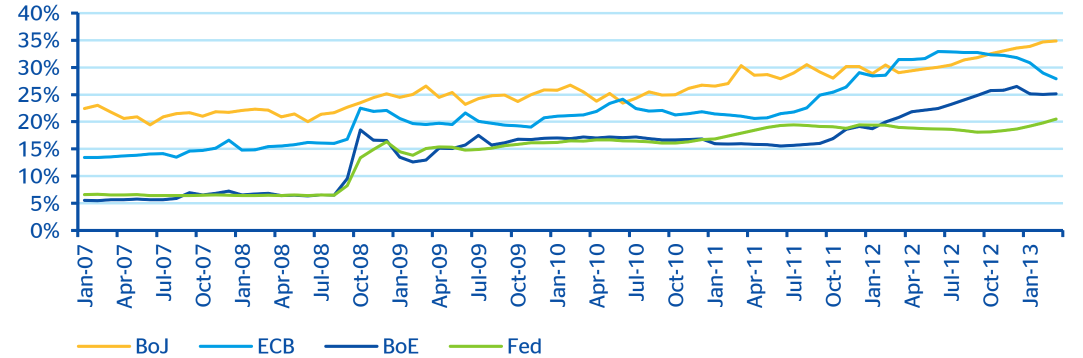
Source: Bloomberg and BBVA Research

Chart 8
Composite index of financial fragmentation in the eurozone



Source: Bloomberg and BBVA Research

Chart 9
Central bank balance sheet as % of GDP



Source: Bloomberg and BBVA Research

Box 1. ECB prepared to continue to provide support

At its May monetary policy meeting, the ECB reduced the main refinancing rate by 25 basis points, held the deposit rate at 0% and reduced the marginal credit facility to 1%. The ECB also announced that eurozone banks would be provided with as much liquidity as they require until at least July 2014 . This means the downward rate trend emphasised at previous meetings and in speeches by various ECB board membershas materialised. The decision therefore had little impact on the market.

The ECB's decision was naturally heavily influenced by the weakness of growth in the eurozone, which is extending into the second quarter and, above all, is spreading to a growing number of core European economies. Nonetheless, a number of external events are also shaping the ECB's actions. In recent months, the dynamism of global growth has sparked doubts and other central banks are adopting new measures. In April, the Bank of Japan announced an unprecedented monetary expansion (the mass purchase of assets, chiefly Japanese government bonds) with the explicit aim of doubling the money supply in two years, and raising inflation to 2%. As in the wake of the announcements of the successive rounds of quantitative easing by the Fed, this decision is having an impact on the international debt, equity and currency markets.

The interest rate cut is likely to have a modest impact on activity. While the measure could have some effect in the core euro economies, the benefit for the peripheral economies is more questionable given the still high - albeit narrowing - level of fragmentation. The monetary policy transmission mechanism is therefore still far from effective.

However, beyond the effectiveness of the cut, the ECB is taking several steps that send out a clear message. First, the bank has made clear its readiness to cut rates if necessary, and even to cut the deposit rate below 0% (a move it had appeared to rule out previously). It is therefore sending out a clear message that it is prepared to use the limited scope it has for action on interest rates. The prospect of the deposit rate being taken into negative territory is also exerting downward pressure on short-term interest rates for sovereign debt and the euro. Second, the extension of full allotment by at least a year means the ECB is sending a clear message to the banking system: liquidity is guaranteed and shouldn't therefore be an obstacle to lending. At present, there are no signs that liquidity poses a problem to the system, as evidenced by the repayment of the two three-year LTROs (over 27%). Nonetheless, the ECB would be prepared to continue using LTROs if necessary. And third, the ECB has also recently included innovative elements into its communication in relation to the anchoring of monetary policy expectations ("guidance"), indicating that its stance will remain accommodative "for as long as needed."

In sum, these measures are insufficient to tackle the lack of lending to SMEs, which is increasingly giving cause for concern. So what can the ECB do against this backdrop? The ECB itself has admitted that it has very limited scope for action and is therefore exploring ways of collaborating with other community institutions such as the EIB (European Investment Bank) with a view to kickstarting lending. The ECB has already expressed hopes for a revival of the the European market for asset-backed securities , driven by lending to companies, but other options are also being weighed up (financing along the lines of the *"Funding for Lending" scheme. launched by the Bank of England).*

In our core scenario, which sees the European economy starting to pick up in the second half, rates are likely to remain at around 0.50%; however, the trend is clearly downward. Moreover, whilst downside risks for growth persist and lending remains in the doldrums, fresh action from the ECB cannot be ruled out.

Box 2. Fiscal policy: The deficit targets are eased across the board due to greater than expected cyclical deterioration

Europe registered a decrease in GDP that intensified in the last quarter of 2012 (-0.6% qoq after -0.1% in 3Q12) which had a negative impact on the public accounts, which closed the year with a deficit of -3.7% after posting a deficit of -4.1% in 2011.

The immediate result of this worse economic performance and of the more pessimistic forecasts was the resetting of the timetable for the fiscal adjustments, which has also been linked to the controversy generated by the International Monetary Fund regarding the magnitude of the fiscal multipliers and the rate of adjustment. In general, it appears reasonable to focus the fiscal adjustment on the structural deficit and not on the entire deficit, which as a result would not compensate for the deviations in the deficit for cyclical reasons.

In recent months, many countries have presented new, slower adjustment plans, as the European Commission has accepted or made it clear that it would accept the changes. In Greece, the primary surplus target of 4.5% has been delayed until 2016, two years later than initially projected. Portugal will have another year (up to 2015) to reduce the nominal deficit to under the 3% level (Box 3). Targets for 2013 have also been made easier for countries such as France (from -3% to -3.7%), Italy (from -1.7% to -2.9%), Spain[3] from -4.5% to -6.3%) and the United Kingdom (from -6.3% to -6.8%). However, Germany has its public accounts in order, and has maintained its objective of -0.5% for its fiscal balance for 2013, after having obtained a surplus of 0.2%. In the following section we will focus on the budget plans of France, Italy and Spain.2012.

France

The deficit in 2012 was -4.8% of GDP, 0.4pp less than in 2011 and 0.3 pp higher than recent estimates (BBVA and Government forecasts -4.5%). This difference is mainly due to an upside deviation in the structural deficit amounting to about -3.7% of GDP (BBVA -3.4%), while the cyclical deficit and the interest payments were, according to our calculations, about -1.1% and -2.6% respectively (Chart 10).

For 2013 the French government increased its nominal public deficit forecast from -3% to -3.7%, which was presented in Brussels in its budget plans. This revision was mainly due to the worse growth outlook (the new government forecast is +0.1% in 2013, while the previous one was +0.8%) and the base effect of a higher than expected deficit in 2012 (-0.3pp).

Therefore, the main measures being implemented to reduce the deficit remain, in general terms, the same ones that have been approved in the budget, despite the change in the deficit targets, and are mainly based on tax increases: 1) Lower deduction for interest paid on loans (the level drops from 100% to 85% for the year ending on 31 December 2012, and to 75% for 2014); 2) reduction in the exemption of long term capital gains obtained from selling stock (from current 90% exempt to 88%); 3) elimination in the reductions in the wealth tax introduced by the previous government; 4) introduction of a new marginal rate of 45% for income of over 150 thousand euros; and 5) reform of the tax treatment for capital inflows, which will now be subject to the marginal rates used for other income sources instead of at a fixed rate.

The French Constitutional Court declared certain fiscal measures approved by the new French government to be unconstitutional, including the introduction of a marginal rate of 75% for income tax and part of the taxes relating to capital gains. However, the budgetary cost of eliminating these measures is very low (less than 0.1% of GDP. 500 M euros).

With these measures, we expect the public deficit in 2013 to be -3.8% of GDP, 0.1pp higher than the official estimate. From a nominal deficit of 4.8% in 2012, the reduction in the deficit via structural measures in 2013 is 1.5% of GDP, but will be compensated on the upside by the increase in the cyclical deficit of 0.5pp of GDP due to the stagnation of the economy. Of this 3.8% deficit, 2.2pp is structural deficit, which is the adjustment that France must make in the coming years to balance its accounts in structural terms. In the new calendar, this balance is scheduled to be reached in 2016 (structural deficit of 0.2% of GDP), one year after it was slated to be reached in the Stability Programme presented in 2012. The objective of obtaining a nominal deficit of under 3% of GDP has also been postponed a year, to 2014 instead of 2013.

3: For more details, see Spain Economic Outlook (2Q2013): http://serviciodeestudios.bbva.com/KETD/ketd/ing/nav/geograficas/espana/historico/publicaciones/observatorios/observatoriosecon/index.jsp

Italy

The deficit at the end of 2012 was -2.9% of GDP, practically in line with our last forecasts and the revised target of the government (BBVA and Government: 2.8%). The structural deficit was 1.8%, with a cyclical deficit that we estimate at -1%, while interest payments amounted to -5.3% (see chart 11).

The new deficit target set for 2013 is below the 3% level (-2.9% of GDP), although it has been revised upwards from the -1.7% announced at the beginning of 2012. This revision is due mainly to the worse growth forecasts (from initial -0.2% to -1.3% in 2013) and to the inclusion of the impact of the settlement of the State's debts, which totalled 40 billion euros (2.6% of GDP). Furthermore, the Italian government estimates that this liquidity injection will have a positive impact on growth of 0.2pp in 2013, 0.7pp in 2014 and 0.3pp in 2015.

The new government has declared its commitment to not only finish the year with the deficit at the limit set by Maastricht (3% of GDP), but also to reach a balanced structural budget, in accordance with the stipulations of the fiscal agreement. However, the recent announcement by the new government constituted at the end of April that it would not implement the increase in VAT to 22% (from previous 21%), as well as the suspension of the property tax on primary residences until the new real estate tax system enters into force could cause a deviation in the deficit target of 0.4pp, i.e. the deficit could reach 3.3% of GDP. Therefore, our deficit forecast for this year of -2.9% could be subject to risks.

The main reason that our base scenario envisages compliance with the deficit target for 2013 is because the structural effort, according to our calculations, will be about 0.2% of GDP, the lower effort of the last 2 years (in 2012 the effort was 1.8% of GDP and in 2011, 1%).

Spain[4]

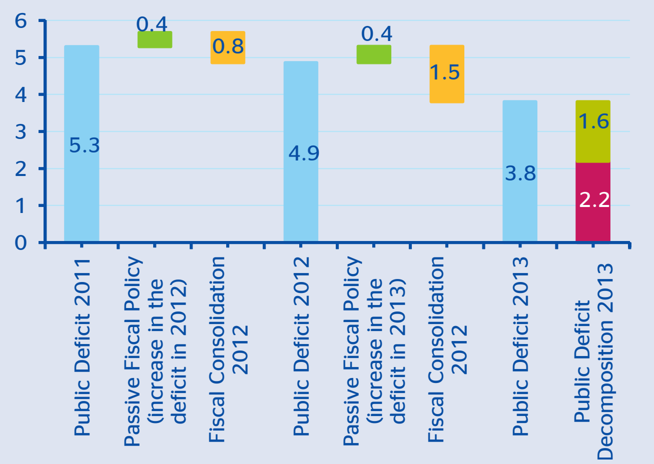
The Spanish public administrations closed 2012 with a deficit of 7% of GDP, excluding the assistance given to the financial sector (3.6% of GDP), slightly better than expected (BBVA: 7.2%) and 0.7pp higher than the year-end target (Government: 6.3%). The nominal deficit in 2012 decreased by 2pp of GDP, while the structural deficit decreased by about 3.9pp to 3.3% of GDP. Moreover, when interest payments on the public debt (which amounted to 3% of GDP in 2012, 0.5pp more than in 2011), are taken out of the analysis, the adjustment of the primary structural deficit would be greater than the 4.4pp of the GDP, putting it very close to the budgetary balance (0.3% of GDP),

The Government has revised the deficit targets for 2013 and 2014 to 6.3% and 5.5% respectively, from 4.5% and 2.8%. To reach these new targets, the 2013 National Reform Plan presented together with the updated 2013-2016 Stability and Growth Pact includes certain measures aimed at cleaning up the balance sheet of public accounts. On the revenues side, new tax increases have been announced - through the creation of new environmental taxes, an increase in special taxes, and a new modification to the corporate tax, which are in line with the recommendations of the European Commission, aim to shift the tax load away from work and towards consumption, but do not represent a true fiscal reform. However, on the spending side, the measures that have already been announced remain in place, and the main plans entail the expected reform of the Public Administrations, with the draft Local Government Rationalisation and Sustainability Act Project and the Public Administration Reform, which could extend into the second half of the year, with the expected saving not being booked until the start of 2014.

In 2013, we expect the deficit to be slightly above the established target (6.3%, BBVA 6.5%), since we expect the fiscal adjustment policies to continue and to be insufficient to offset the negative effects of the decrease in activity on revenues and spending and the expected increase in interest payments. Therefore, our forecasts indicate that in 2013 the cycle will shave off slightly over 1pp of GDP from expected revenues, affecting both the taxes on production and income taxes and social contributions, and absorbing the structural improvement in same. Therefore, public revenues will represent about 36.8% of GDP, barely 0.2pp over what was registered in 2012. In addition, the adjustment to spending in 2013 will be concentrated on the public sector salaries (mainly due to the permanent status of the reform measures relating to the public sector), on the rest of current spending, and to a lesser degree on investment spending, which will slow its rate of decline with respect to previous years.

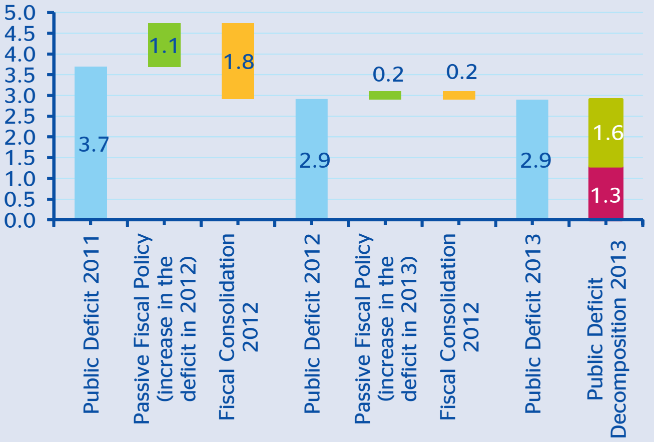
4: For a more detailed description, see Spain Economic Outlook (2Q2013): http://serviciodeestudios.bbva.com/KETD/ketd/ing/nav/geograficas/espana/historico/publicaciones/observatorios/observatoriosecon/index.jsp.

Chart 10
France: Fiscal Consolidation 2012-2013 and Deficit Decomposition in 2013 (% of GDP)



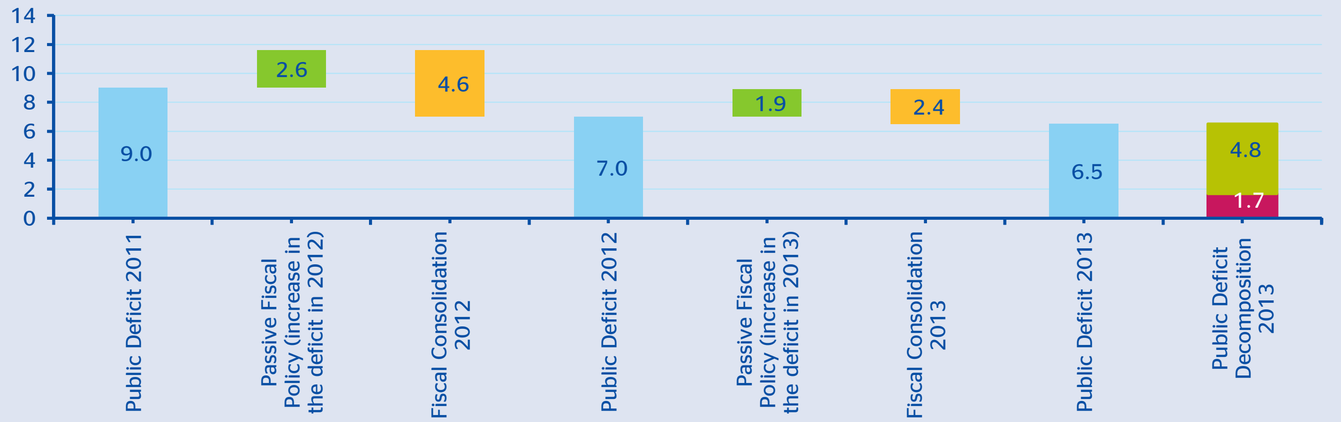
Note: Green: Cyclical component; Pink: Structural component.
Source: BBVA Research based on HAVER Analytics data

Chart 11
Italy: Fiscal Consolidation 2012-2013 and Deficit Decomposition in 2013 (% of GDP)



Note: Green: Cyclical component; Pink: Structural component.
Source: BBVA Research based on HAVER Analytics data

Chart 12
Spain: Spain: Fiscal Consolidation 2012-2013 and Deficit Decomposition in 2013 (% of GDP)



Note: Green: Cyclical component; Pink: Structural component.
* Excluding the aid to financial institutions
Source: BBVA Research based on HAVER Analytics data

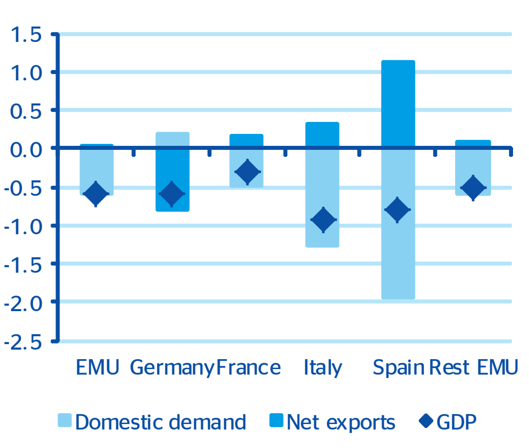
4. Eurozone economic outlook

Following widespread recession in 4Q12 …

The contraction in eurozone GDP gathered pace in 4Q12 (-0.6% q/q, on the heels of a decline of -0.1% q/q in 3Q12), dragged by domestic demand (-0.6pp, in line with previous quarters), but mostly on account of the sudden disappearance of the positive contribution by the external sector (net contribution to GDP of 0.0pp vs. +0.4pp in prior quarters). Export activity contracted sharply, affected by the slowdown in emerging markets and the US, albeit mitigated by a decline in imports of similar scale.

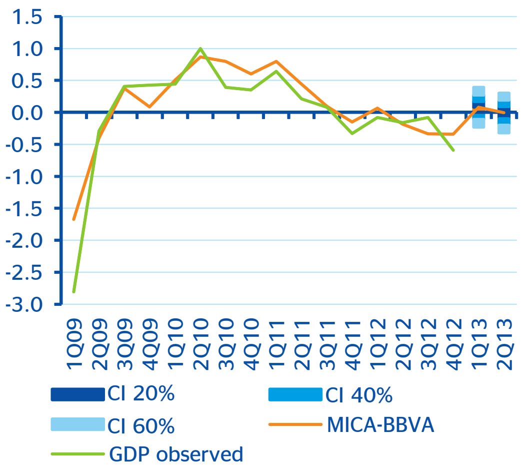
The reduced contribution from exports was widespread across countries in the eurozone, although the impact was varied due to differing trends in domestic demand and, by extension, import activity (Chart 13). Thus, net exports eroded growth in Germany by -0.8pp, driving a q/q GDP contraction of -0.6%, while in the rest of the eurozone nations, the external sector continued to make a positive contribution, albeit insufficient to offset the drastic drop in domestic demand, with economic activity collapsing in Italy (-0.9% q/q) and Spain (-0.8% q/q). The contraction was a more moderate -0.3% Q/q in France, compared to a decline of -0.5% q/q in the rest of the eurozone.

Chart 13
GDP growth (% q/q) and contributions in 4Q12



Source: Eurostat and BBVA Research

Chart 14
EMU: MICA-BBVA and GDP observed (% t/t)



Source: Eurostat and BBVA Research

… there are certain signs of stabilisation in the early part of the year…

Based on all the data available for 1Q13 (quantitative data to February), our MICA-BBVA model[5] points to GDP growth of 0.1% Q/q in 1Q13 (Chart 14), in line with our macroeconomic scenario, although we see some downside risks insofar as confidence indicators suggest a slight slowdown in economic activity towards the end of the first quarter, as may become evident in hard data for March, which still have to be released. In all, the probability of another contraction in GDP in 1Q13 according to the MICA-BBVA model is almost 40%, hardly negligible.

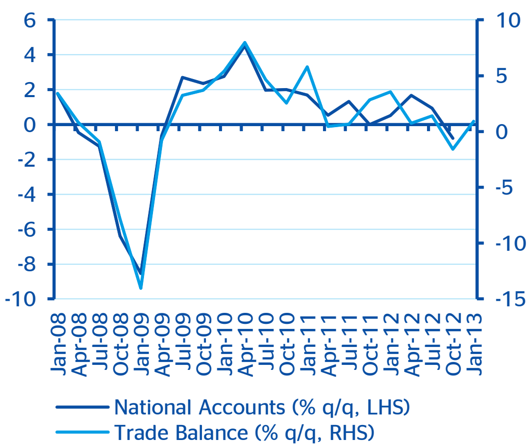
5: For a detailed description of this model, see the working document, "The Euro-Sting revisited: PMI versus ESI to obtain euro area GDP forecasts", which can be found at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1120_tcm348-260444.pdf?ts=622013

As we anticipated in our last report (Europe Economic Outlook, First Quarter 2013), the slowdown in global demand in 4Q12 would have been temporary, with activity already showing signs of traction in early 2013 (BBVA-GAIN chart, Chart 4)[. This would be reflected in the trend in overall eurozone exports in the early months of 2013 (Chart 15): to February exports were up by 0.9% over 4Q12 levels, while imports were flat. These numbers are also in line with our macroeconomic scenario which expects a positive net contribution to growth by exports once again in 1Q13 (+0.2pp).

The more dynamic performance of global demand also seems to be having an effect on industrial production, which may well hold steady in 1Q13, having contracted by -2.1% q/q in 4Q12, underpinned by a slower decline in production of intermediate and capital goods and, above all, growth in the production of non-durable consumer goods. This increase in production, coupled with the brighter outlook for external demand and the ongoing reduction in inventories initiated last year, point to a definite easing in the pace of contraction in investment in the early part of the year (-0.2% q/q, in the wake of a decline of -1.2% in 4Q12). Despite the deterioration in the labour market, consumer confidence continued to improve and retail sales showed signs of greater resistance, increasing slightly until February, after the steep drop in 4Q12. Overall, our models point to a slight contraction in private spending in 1Q13 (-0.1% q/q vs. -0.5% q/q in 4Q12). Lastly, the fiscal consolidation effort implies that public spending looks set to continue to detract marginally from growth (-0.1% q/q). As a result, our forecasts call for a clear-cut reduction in the negative contribution by domestic demand in 1Q13: an estimated -0.1pp after -0.6pp in 4Q12.

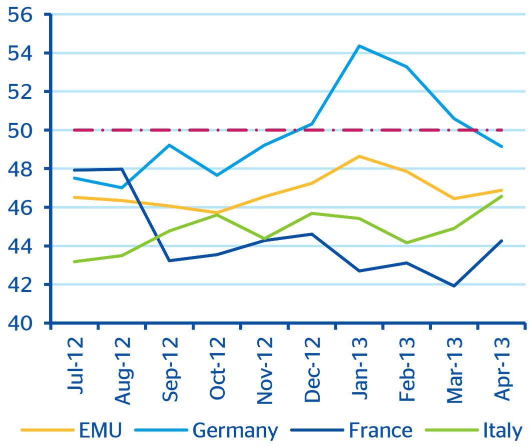
By country, our models suggest that only Germany will register growth in 1Q13 (+0.4% q/q vs. -0.6% q/q in 4Q12), while the French economy should stabilise (vs. -0.3% q/q in 4Q12) and with the recession easing in Spain (-0.5% vs. -0.8%) and Italy (-0.3% vs. -0.9%).

Chart 15
EMU: Exports (% q/q)



Source: Eurostat and BBVA Research

Chart 16
Confidence: Composite PMI



Source: Markit Economics

… although certain leading indicators suggest that the peripheral crisis may have touched central Europe, possibly pushing back recovery in the region as a whole

Although 2Q13 data are still very scarce, limited essentially to confidence readings for April, both the European Commission confidence indicator and the PMIs reveal a widespread dip in confidence for the second month in a row, wiping out the gains registered between December and February (Chart 16). These indicators suggest that the crisis-hit periphery may be having a sharper impact on the core nations. Expectations for the German manufacturing sector fell sharply, particularly on account of demand from the rest of the monetary union member states, while uncertainty regarding the definitive resolution of the European economic crisis continues to clearly affect spending and investment decisions.

Based on this – very limited – information, our MICA-BBVA model (Chart 14) points to renewed deterioration in economic activity in the region, perhaps even a contraction, introducing a clear downside bias to our projections and the possibility that the recovery could be pushed back to the second half of the year.

Triggering a new ECB intervention and the relaxation of short-term deficit targets

These somewhat worse-than-expected indicators, coupled with a higher than forecast dip in inflation (1.2% y/y in April), prompted the ECB to cut its benchmark rate by 25bp to 0.5% and expand its unlimited liquidity auctions until at least mid-2014 (six months later than originally announced) (Box 1). Despite announcing the launch of initiatives with other European institutions to jointly promote private sector lending activity, the ECB has yet to announce concrete measures aimed at rapidly reversing prevailing financial fragmentation (Chart 8).

In addition, given the significant deterioration in activity along the periphery and, by extension, in these nations' public finances, the European Commission appears to be ready to take the approach when examining the national stability programmes presented to it of focusing on deficit numbers in structural terms, leaving aside nominal deficits, paving the way for relaxation of nominal budget targets for the time being (Box 2).

Slight economic contraction in 2013 followed by sub-par growth in 2014

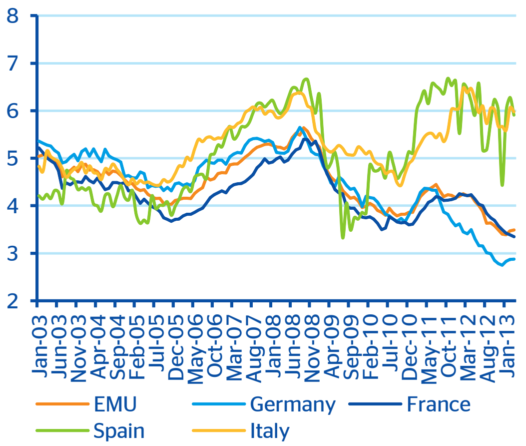
The biggest surprise with respect to the assumptions underpinning our forecasts of three months ago was the higher-than-forecast impact of the slowdown in global demand (mainly in the US and Asia) and euro appreciation on exports in the last quarter of last year. It is also worth highlighting the lower-than-forecast impact of the sharp reduction in financial stress towards the end of last year on the real economy, although we had flagged the fact that this knock-on effect would take time. Easier access to borrowings and lower borrowing costs for sovereign issuers has not been accompanied by a similar impact on private sector funding, so that households and companies across the various member states face very different lending terms (availability and cost), further undermining domestic demand in the countries continuing to experience a credit crunch.

All of the foregoing drove a higher-than-forecast GDP contraction in the eurozone (-0.6% q/q in 4Q12 vs. our estimate of -0.4% q/q) and economic stagnation in early 2013 (we had been forecasting an incipient recovery), with a negative knock-on effect on our growth forecast for 2013 of around -0.2pp.

This, coupled with the evidence that the peripheral crisis is affecting central Europe, has prompted us to revise downwards our growth scenario by -0.4pp to -0.1% in 2013 and by -0.3pp down to 1% in 2014 (graph 18). This scenario continues to assume that the recovery will gain traction over the course of the second half of this year.

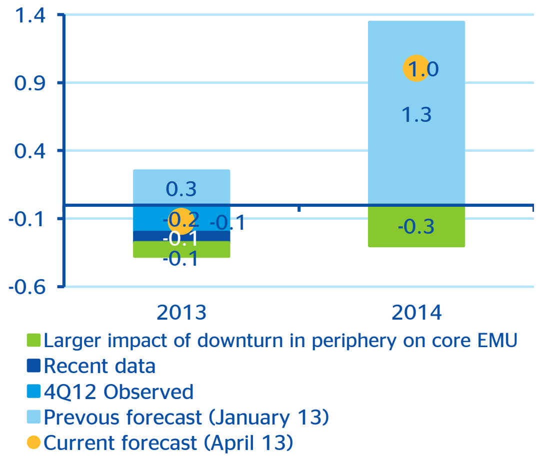
However, it is important to stress that these estimates depend crucially on how the eurozone crisis is managed in the coming months. Specifically, we are assuming that the European authorities will continue to make progress on banking union, gradually helping to restore the flow of credit to the peripheral nations' private sector. We are also assuming that the member states, particularly the peripheral nations, will forge ahead with their fiscal consolidation efforts and the correction of their internal and external imbalances. In sum, our scenario assumes that financial stress and reduced uncertainty regarding the euro's survival would stay at current levels, with some ups and downs, throughout the entire projection period.

Chart 17
Interest rates on new loans to businesses



Source: BBVA Research

Chart 18
EMU: Annual GDP growht and drivers



Source: ECB

Internal demand is expected to continue to erode growth in 2013 but to contribute to recovery in 2014

Given the slow correction and recovery in certain drivers of domestic demand, we expect that this segment will continue to erode growth in 2013 (-0.9pp), albeit far less drastically than in 2012 (-2.1pp), as we are considering an incipient recovery in private spending and investment in the second half of the year; this force should gather traction in 2014 with domestic demand taking over from net exports as the main growth engine (+0.9pp) (Chart 19).

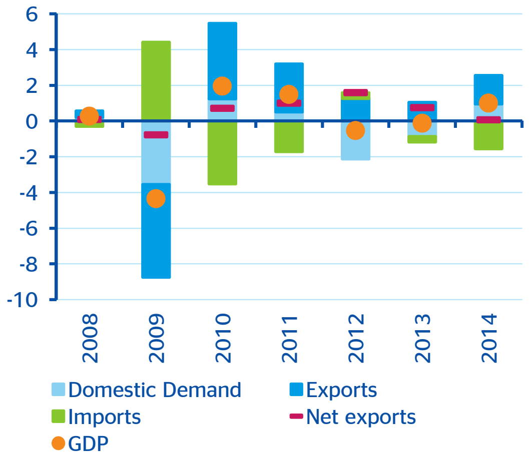
On the private consumption front, the ongoing deterioration in the labour market (a little over 2pp since mid-2011 and almost 5pp since 2008), coupled with the increased tax burden implied by the fiscal consolidation effort and high inflation levels, has sharply eroded disposable household income (by around 2% in 2012 and by just under 5% since 2009), which will clearly continue to weigh on private spending. However, the reduction in the household savings rate (by around 1pp in 2012 and just over 3.5pp since 2009, due to the reduction in precautionary savings on the back of higher confidence levels), together with the anticipated moderation in inflation, could partially mitigate this phenomenon. In addition, particularly on the periphery, household deleveraging continues. Combined with restrictive financing terms and still-low confidence levels, this leads us to forecast further contraction in private consumption in 2013 around 0.6% (having contracted by -1.3% in 2012). This forecast considers an outlook of broadly flat consumption in the first part of the year, following by a timid recovery in the last quarter.

Weak private demand, together with the slump in exports and increase in idle capacity, is expected to drive again to a contraction in investment in 2013 (-1.6% by our estimates), albeit less marked than that of last year (-3.9%), dragged mainly by the anticipated decline in investment in capital and transport goods; while the reduction in construction investment will continue to be shaped by cuts in public spending. In addition, the weak outlook for demand is likely to once again result in inventory destocking, detracting from GDP growth by around -0.2pp.

The imperative need to make public finances sustainable (despite the easing of deficit targets in several member states), coupled with scant room for manoeuvre in terms of fiscal policy, will translate into clearly pro-cyclical government spending once again in 2013. We are forecasting a slight contraction in public spending (-0.3%). As a result, the eurozone public deficit should fall by 1pp to 2.7% of GDP this year, with an increase in the public debt-GDP ratio to 95.2%.

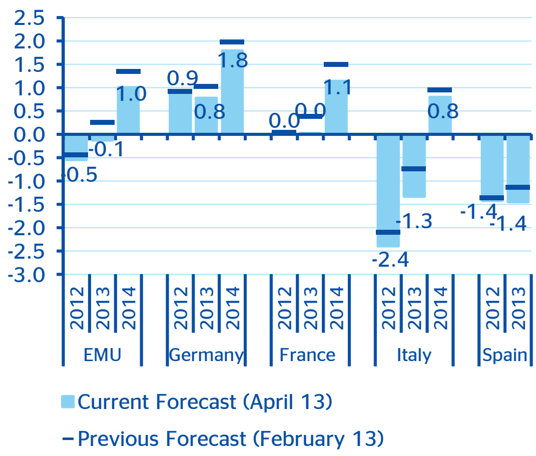
Our model assumes that many of the austerity measures underway will cease to have a meaningful impact on the real economy in 2014. On the one hand, the fiscal consolidation work of recent years should drive an improvement in public finances, ensuring their sustainability and eliminating the risk of a new sovereign debt crisis and, by extension, stress for the banking system. On the other hand, bank sector restructuring in several peripheral nations, together with progress on the banking union front, should restore the flow of credit to the private sector. Overall, we are forecasting a widespread improvement in all components of domestic demand: growth in private spending (0.6%) and investment (3.2%), with public spending no longer eroding growth.

Chart 19
EMU: Annual contribution to growth (pp)



Source: Eurostat and BBVA Research

Chart 20
EMU: Growth forecasts by country



Source: Eurostat y BBVA Research

Exports set to remain the growth engine in 2013 and 2014

In 2013 exports will continue to benefit from sustained global economic growth (3.3%), although we expect the annual average growth rate to decline again due to the knock-on effect of the sharp drop sustained in 4Q12. Also, imports are likely to prove more resistant (0.8%), making a positive contribution to the external sector of 0.7pp (easing from 1.6pp in 2012), insufficient to offset the reduced drag posed by domestic demand. Export growth is expected to accelerate in 2014 (3.5%), underpinning the recovery in investment, although the rebound in imports (3.7%, driven by the recovery in domestic demand) will wipe out the export contribution in net terms (0.1pp) (Chart 19).

Labour market not expected to improve until 2014

Against this backdrop, and given the job creation lag, our forecasts assume that the labour market will continue to deteriorate in the coming quarters, albeit showing signs of stabilisation in the second half of the year. As a result, we are forecasting a fresh decline in employment (-0.6%, vs. -0.7% in 2012) which would drive the unemployment rate up by around 0.8pp to 12.2%. According to our projections, consolidation of the recovery in 2014, with the economy set to grow a little under its potential rate, should pave the way for job creation (0.4%) to bring the unemployment rate just below 12% once again.

Germany the sole growth engine in 2013, with the periphery in recession

The widespread intensification of the recession in the last quarter of 2012, coupled with evidence of a growing adverse impact of the peripheral crisis on the core eurozone economies in the early part of this year, has prompted us to reduce our growth forecasts for all countries, particularly the peripheral nations, but also France (Eurozone member states: detailed analysis Table).

Our new forecasts assume that only the German economy will register growth this year, although less vigorously than in 2012 (+0.8%), thanks to the relative strength of the country's internal demand fundamentals. In France, despite relaxation of the deficit targets, uncertainty regarding which fiscal measures the government will ultimately implement has weighed heavily on confidence and will magnify domestic demand weakness, which is expected to continue to undermine growth this year, offsetting the positive impact of net exports to leave the French economy stagnant. The peripheral economies need to continue to address their economic imbalances and tackle the fragmentation of their financial markets which is leaving their borrowing costs still too high. We are currently forecasting a contraction in the Spanish economy in 2013 in line with that of 2012 (-1.4%), with the contraction in Italy easing (from 2.4% in 2012) to a still formidable decline in growth of 1.3% this year.

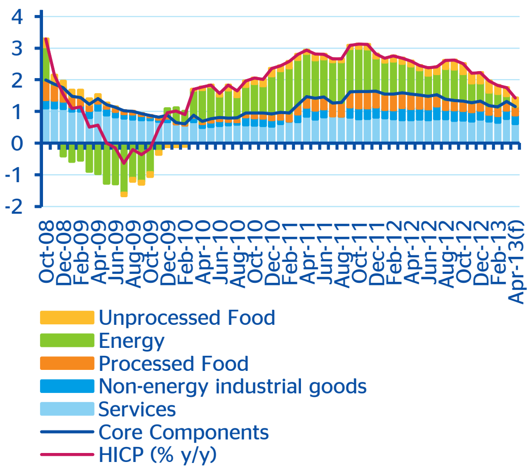
We are not forecasting a return to widespread growth across all member states until 2014. The differences will remain pointed, with the core nations continuing to grow above the eurozone average (1%) and the peripheral nations underperforming this trendline (Chart 20).

Inflation is already tracking below the ECB target and is expected to stay there throughout the projection period

Inflation continued to ease throughout the first quarter, declining by 0.4pp to 1.9% y/y (on average in 1Q13), as forecast, due mainly to lower growth in energy prices but also a 0.1pp reduction in core inflation to 1.5% y/y, mirroring the weak state of domestic demand. Moreover, the reduction in headline inflation intensified in April, falling to 1.2% y/y compared to 1.7% y/y in March, somewhat more than forecast, not so much due to energy prices as the impact of the timing of the Easter holidays this year compared to last, driving a reduction in service prices; core inflation, meanwhile, dropped roughly 0.4pp to 1.2% y/y in April (Chart 21). Due to this transitory phenomenon, we are expecting inflation to tick higher once again in the middle part of the year only to ease again and fluctuate at around 1.4%-1.5% during the second half of the year. As a result, we are forecasting average headline inflation in 2013 of 1.6%, 0.9pp below the 2012 rate (Chart 22). It is also probable that core inflation will tick a little higher in the months to come, holding relatively steady at around 1.4% y/y in the second half for an average annual rate of 1.5% in 2013.

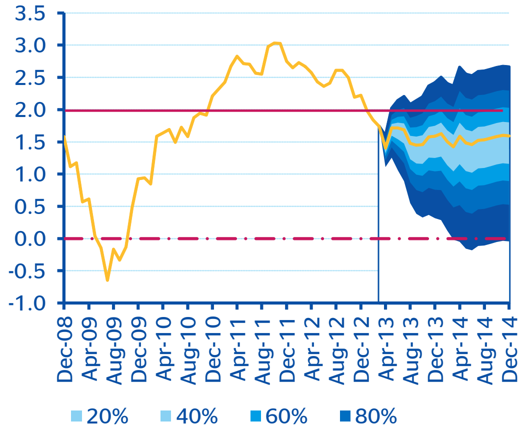
Inflation should hold relatively stable also in 2014, shaped by the lack of inflationary pressures on the demand side, all the more so now that the relaxation of deficit targets has allayed the likelihood of fresh tax hikes during the projection period. In sum, although uncertainty regarding the outlook for certain exogenous variables (commodity prices) and/or discretionary factors (administrated prices, taxes) remains relatively high, inflation risks remain in check.

Chart 21
EMU: Inflation (% y/y) and contributions by component



Source: Eurostat and BBVA Research

Chart 22
EMU: Inflation (% y/y)



Source: Eurostat and BBVA Research

Downside due to risk factors related to developments on the periphery, progress on banking union and the environment beyond the eurozone

The limited impact of the turmoil in certain eurozone markets in 1Q13 (banking crisis in Cyprus, Italian elections, 2012 deficit target misses) confirm that the measures announced at the European level last year have served to put a lit on the crisis, reducing the probability of a harsh recession in the monetary union. However, uncertainty remains as to whether the European authorities will be able to take advantage of this window of opportunity.

Either way, there is still more downside than upside bias to our estimates. There is still a risk of fresh bouts of financial turmoil due to issues on the periphery. The sources of risk are varied. For example, the Italian government may not be able to offset the fiscal austerity measures it has promised to roll back, possibly fuelling widening in the Italian sovereign debt premium with scope for knock-on effects on the rest of the periphery and a banking system still in the throes of restructuring. Meanwhile, the difficulties intrinsic to implementation of the sharp fiscal adjustments are coming to the fore in other member states, such as Portugal, weakening governments and sparking social protests. A bailout in Slovenia or troubles implementing reforms and/or cuts in other countries cannot be ruled out.

Elsewhere, we continue to see execution risk despite the progress made at the European level, in terms of both the possible reactivation of the ECB's OMT programme and, above all, possible delays in reaching key banking union milestones. Financial fragmentation could be exacerbated as a result, further choking the flow of credit to the periphery.

Lastly, there are also sources of risk outside the eurozone, such as the risk of an economic slowdown in emerging markets (especially in Asia) and/or the US, as well as the risk of a stronger euro as a result of reduced intervention on the part of the ECB with respect to other central banks (the Fed and the Bank of Japan), possibly putting a dampener on the region's key growth driver (particularly in the periphery), that is, exports.

Eurozone member states: detailed analysis

Germany: recovery is already underway but the recession in the peripheral states could undermine the strength of domestic fundamentals

GDP: +0.0% in 2013 1.1% in 2014 HICP:+1.4% ien 2013 +1.5% in 2014

Latest official information for 2012: economic growth declined steadily over the year, and shrunk significantly at the end of the year in 4Q12 (-0.6% q/q; BBVA Research: -0.4% q/q). The reason for this decline was the deterioration of exports, which contracted significantly at the end of the year (-2% q/q, 4.3% in 2012) because they were weakened more than expected by the slowdown in growth in Asia and the US, the worsening recession in the other countries in the euro zone, and the appreciation of the euro. Despite this, net exports contributed 1.2pp to GDP growth in 2012. Nonetheless, the decrease in demand from outside Germany could also be seen by the fall in investment (-1.9%) and the ongoing reduction in inventories (-0.6pp) during the year as a whole, which was not offset by the resilience demonstrated by private consumption (0.6%) and the support from public consumption (1.4%), resulting in a negative contribution from domestic demand (-0.3pp). As a result, GDP was up just 0.9% in 2012, down from 3.1% in 2011.

Estimates for 1Q13: the available indicators suggest that GDP would already be on the up again at the start of the year (0.4% q/q). The resilience of the labour market, with employment increasing at a constant rate of approximately 0.2% q/q, and the jobless rate pegged at 5.4%, again supported consumers' increased confidence, and was reflected in an increase of 1.5% q/q in retail sales in 1Q13 which, therefore, suggests that private consumption has continued to contribute to growth. Also, information from the balance of trade up to February suggests that the considerable fall in exports at the end of 2012 was temporary, while the recovery in industrial orders in February and March (2.2% MOM), due especially to orders from outside, points in the same direction, improving estimates for the coming quarters. Imports were also down again and, therefore, net exports should have once again contributed positively to the recovery. Rising demand was already reflected in growth in industrial production in February and, particularly, in March, averaging a rise of approximately 0.5% q/q in 1Q13 (-2.6% q/q in 4Q12), while an expected rise in demand should have encouraged investment. However, the deterioration of the confidence indicators in March and April (particularly the PMIs, following the recovery in January and February) increased the doubts surrounding the sustainability of this recovery in activity, although it was not reflected in the quantitative indicators and, particularly, the immunity of the German economy to the crisis in the peripheral states over the coming quarters.

Outlook for 2013 and 2014: our estimates consider a gradual recovery of the economy over the forecast period, underpinned by a rise in domestic demand, substituting exports, which will continue to slow down this year. However, the poorer performance of the economy in 4Q12, together with the potential larger impact of the recession in the peripheral states caused us to revise our forecasts for growth slightly downwards by 0.2pp to 0.8% in 2013 and 1% in 2014. The ongoing improvement in the labour market will result in an increase in salaries which, together with reduced inflation and financing costs, will result in an increase in growth in household consumption to 0.8% and 1.2% in 2013 and 2014, respectively. The improved forecast of the performance in domestic demand and the robust demand from emerging economies, together with low financing costs, should be sufficient to sustain the estimated recovery in investment (0.6% in 2013 and 4.4% in 2014). Furthermore, the adjustments to public finances will make it possible to implement a neutral fiscal policy, aimed at consolidating the recovery. The recovery in domestic demand will make imports more dynamic which, together with the estimated slowdown in exports, will eliminate the contribution of net exports to growth (0.0pp in 2013 and 0.1pp in 2014).

Outlook for inflation: general inflation continued to slow down in 1Q13 by 0.3pp, to 1.7% y/y, as a result of the reduced energy prices, while underlying inflation increased again by 0.1pp, to 1.6% in March, reflecting resilient domestic demand. We consider that the components of inflation will continue to perform in this way in 2013 and, accordingly, underlying inflation will, as a result also of the increase in demand, rise slightly, since higher labour costs could be passed on to the end price, and will then be offset by lower inflation for energy and foodstuffs resulting from the cheaper raw material costs. Therefore, we expect annual average inflation to fall in 2013 by 0.4pp, to 1.7%, remaining relatively stable in 2014 (1.8%), and to stay above the estimated inflation for the euro zone as a whole in both years (1.6% in 2013 and 1.5% in 2014).

Public sector: in 2012 public finances achieved a surplus of 0.2% of GDP, in line with our estimates, but 0.7pp less than the government's deficit target (BBVA: -0.1%; government: -0.5%). The structural adjustment would have been 1.3% of GDP, offsetting the higher-than-expected interest payment (-2.5% compared with an estimated -2.3%). With respect to 2013, the government maintains its deficit forecasts of -0.5% of GDP, which we expect will be achieved in view of the cost margin obtained as a result of the sound performance in 2012. In fact, we estimate that the structural surplus of 2.6% in 2012 will fall to 2.2% in 2013. Public debt represented 81.9% of GDP at the end of 2012, remaining below the euro zone average.

France: the economy will remain stagnant in 2013, while the moderate recovery forecast for 2014 will depend on the economic policy implemented

GDP: +0.0% in 2013 1.1% in 2014 HICP:+1.4% in 2013 +1.5% in 2014

Latest official information for 2012: following a sluggish performance in the first part of last year, the fall in GDP in 4Q12 (-0.3% q/q; BBVA Research: -0.2% q/q) offset a slight recovery in activity during the previous quarter, leading to the stagnation of the economy in the year as a whole. The former was due to the ongoing decline of the fundamentals of domestic demand. Private consumption waned further as observed in the previous year, and it ended up contracting slightly in 2012 (-0.1%) due to the diminishing labour market (around 1pp in 2012, down to 10.6% at the end of the year), tax rises and high inflation (2.2%), given the weak demand, which represented a fall in available income in real terms (around -0.5%) and in household confidence. Therefore, the worse forecast for internal demand, together with the uncertainty of the crisis in Europe, halted investment (0% following 3.5% in 2011) and caused a considerable decrease in company inventories (-1pp) while, unlike other economies such as Germany, exports did not benefit clearly from robust growth in global demand, particularly demand in emerging economies, and slowed down 3pp to 2.5% (lower growth than the average in the euro zone). The saving grace was in the weakness of imports (-0.3%), resulting in a strong positive contribution from net exports (0.8pp) which, together with the recovery in public consumption (1.4%, following 0.2% in 2011), offset the significant fall in private expenditure.

Estimates for 1Q13: available indicators are not very promising since they suggest that the economy could have contracted again at the beginning of the year, which would mean a downward turn in our forecasts with respect to stabilization (BBVA Research: 0% q/q). On the one hand, the confidence indicators showed mixed signs for 1Q13, with the EC indicators showing some improvement up until February, while the PMIs continued their downward spiral, even indicating that the recession might get worse. However, both sets of indicators point towards a steady decline in domestic demand, which seems to extend into 2Q13. With respect to the quantitative indicators, unemployment was up again in 1Q13, around 0.4pp, reaching 11% in March and, therefore, it continued to restrict private consumption, with retail savings remaining sluggish until February and consumer expenditure falling faster (-0.4% q/q following -0.1% q/q in 4Q12). Despite the decrease in demand, the fall in industrial production eased (-0.4% q/q following -2.1% q/q in 4Q12), although the decline in new orders, particularly domestic orders, means that an imminent recovery is not envisaged in the sector and, therefore, in investment. Lastly, the information from the balance of trade until February raises more doubts as to the support from net exports at the beginning of the year since exports continued to fall, albeit at a slower pace, while imports were up slightly.

Outlook for 2013 and 2014: the increasingly weak domestic fundamentals has led us to revise our forecasts for growth downwards, by just under half a point for the whole period forecast, to 0% in 2013 and 1.1% in 2014. Despite the stagnation expected this year, this forecast considers that the economy will begin to recover during the second half of the year. On the one hand, less stringent fiscal objectives announced by the government reduce the uncertainty of the need for a bigger fiscal adjustment and will be a help for consumer confidence, since their available income will not be affected (and will actually benefit from lower inflation), and corporate confidence, since it will provide a respite to already impaired profit margins and the need to reduce costs, meaning that no further jobs will need to be cut in 2013. Accordingly, private consumption will remain sluggish this year, and will grow around 1% in 2014. Improved domestic demand will be strengthened by more growth in exports during the year which, together with the low financing costs, will end up boosting investment, which will recover in 2014 after the fall estimated for the same year. The gradual improvement in domestic demand (-0.3pp in 2013 and 1pp in 2014), also supported by growth in public consumption of around 0.5% in both years, will be reflected by an increase in imports, particularly in 2014, undoing the positive contribution from net exports (0.3pp in 2013 and 0.1pp in 2014).

Outlook for inflation: lgeneral inflation continued to slow down significantly in 1Q13, around -0.5pp, to 1.1% y/y in March. Unlike the decrease observed at the end of last year (also -0.5pp), this performance was also a result of a moderate rise in the prices of raw materials, with a more moderate decrease of -0.3pp in underlying inflation, to 0.9% y/y in March. In view of the sombre economic landscape expected, inflation will remain relatively stable in the coming months, and may increase slightly in the final part of the year due to the recovery in household expenditure. In short, average annual inflation will stand at 1.4% in 2013 and 1.5% in 2014.

Public sector: the deficit in 2012 was -4.8% of GDP, 0.4pp lower than the amount recorded in 2011, and 0.3pp higher than the last estimates (BBVA and government forecasts: -4.5%). Based on our calculations, the difference was due mainly to a reduced structural effort. The forecast nominal public deficit of the French government for 2013 is -3.7%, revised from -3% as a result of a more negative forecast growth in GDP, and the base effect of a deficit that is 0.3pp higher than expected in 2012. The deficit reduction measures are, in general, those approved in the budgets for 2013, and are based mainly on tax increases. We estimate that the public deficit for 2013 will reach -3.8% of GDP, 0.1pp over the official target, which would represent a reduction of -1.5% of GDP in the structural deficit, although it will be offset upwards by a higher cyclical deficit (-1.6% of GDP) due to the economic gridlock. Also, a nominal deficit of less than the 3% threshold will be delayed for a year, and is now set for 2014. Public debt was 90.2% of GDP at the end of 2012, i.e. 4.4 points above the proportion recorded in 2011.

Italy: new downturn in activity in 2013, although at a more moderate rate and already showing signs of recovery in the second half of the year, paving the way for slight growth in 2014

GDP:-1.3% in 2013 +0.8% in 2014 HICP: +2.0% in 2013 +1.7% in 2014

Latest official information for 2012: activity fell somewhat more sharply than expected (-0.9% q/q; BBVA Research: -0.6% q/q) in 4Q12. Particularly noteworthy was the slowdown in exports and, to a lesser extent, further deterioration in investment and private consumption. As a result, GDP contracted -2.4% in 2012 as a whole. Despite the support from outside demand, it was not enough to offset the drastic drop in domestic demand, given plummeting private consumption (-4.3%) and the fall in public consumption (-2.9%), which was reflected in a vehement reduction in investment (-8%) and imports (-7.8). As a result of the latter, the contribution from net exports (2.8pp) offset the negative contribution from domestic demand (-5.2pp).

Estimates for 1Q13: available information suggests the contraction of the economy has eased, in line with our estimated contraction of GDP of -0.3% q/q. Retail sales fell in January and February (-0.5% with respect to 4Q12), an improvement on the fall of -1.1% q/q. Industrial orders were down by -3.5% in the first two months of the year - a similar rate to the one observed in 4Q12. However, there is a clear difference between the performance of domestic and international orders, since the former fell considerably more and proved to be somewhat more resilient than the latter. Industrial production remained virtually stable during the year and, although the industry's confidence data are not very encouraging for March, it all seems to suggest that production will fall at a slower rate. The information from the balance of trade continues to indicate weak exports during the beginning of the year, although we expect that they will continue to be a mainstay for the activity. The scant data available for 2Q13 -basically confidence indicators- seem to suggest that the recession will continue to abate.

Outlook for 2013 and 2014: the recession is expected to ease over the course of 2013 and a slight recovery is expected to be observed next year. Estimated GDP for 2013 was revised downwards although we continue to expect a smaller recession than the one seen in 2012. We currently estimate a fall of -1.3%. The estimate for 2014 was remained virtually unchanged (0.8%). In 2013, domestic demand could contribute -2.4 points to growth in GDP since investment (-3.8%), private consumption (-2.3%) and public consumption (-1.5%) are expected to fall considerably. With respect to the outside sector, this year a positive contribution of 1.1pp is expected as a result of growth in exports and a fall in imports. However, in 2014 both domestic and international demand are expected to contribute positively to growth (both by 0.4pp). Virtually all components of domestic demand are forecast to go from negative to positive, particularly investment, for which growth of 2.7% is expected following the significant fall last year. Stronger domestic demand in 2014 will lead to an increase in imports, which will reduce the positive contribution of net exports.

Outlook for inflation: following an increase in 2012, the inflation rate is expected to decrease in 2013, to 2% in 2013, and 1.7% in 2014, as a result of the reduced inflation relating to energy but, also, the estimated reduction in underlying inflation. However, there is a high degree of uncertainty since the consolidation process could affect prices, particularly following the announcement of the freeze on the hike in VAT, which would adjust our inflation estimate downwards.

Public sector: 2012 ended with a public deficit that accounted for -2.9% of GDP, virtually in line with our estimates and the government's revised target (BBVA and government: -2.8%). The structural deficit was -1.9% and the estimated cyclical deficit -1%. The interest payment was -5.4% of GDP. The new deficit target for 2013 is -2.9% of GDP, which has been changed from -1.7% announced at the beginning of 2012, due to the more negative forecasts for growth and the inclusion of the impact of the liquidation of state debts. Our base scenario forecasts compliance with the target deficit, and that the structural effort will be lower than it was during the last two years, although there are certain risks that could alter the deficit target by approximately +0.4pp, such as the cancellation of the hike in VAT, together with the cancellation (in principle, temporary) of the implementation of a property tax. At the end of 2012, public debt stood at 127% of GDP, 6.2pp higher than the amount recorded at the end of 2011.

Spain: economic activity will shrink again in 2013 and will grow in 2014

GDP:-1.4% in 2013	0.9% in 2014	HICP: 1.7% in 2013	1.2% in 2014

Latest official information for 2012: during the last quarter of 2012, the Spanish economy contracted -0.8% q/q. The contraction as a percentage of actual GDP closed the whole year at -1.4%. This slowdown in activity was due to the contraction in domestic demand, which contributed -3.9pp to growth. Conversely, international demand once again acted as a balance, contributing 2.5pp to growth, thanks to the increase in exports and the reduction in imports. In 2012 investment plummeted again, due mainly to the considerable deterioration in investments in construction.

Estimates for 1Q13: the forecast growth in GDP points towards a contraction of -0.5% q/q in the Spanish economy in 1Q13, meaning that the deterioration in activity would have moderated in the last three months, albeit less than expected (BBVA Research: -0.3% q/q). Available information to date suggests a smaller contraction in domestic demand, which in turn would take 0.9pp off growth. With respect to international demand, an upward adjustment was observed in the first quarter following the temporary fall at the end of 2012, confirming the international sector as a pillar for recovery, with a contribution of 0.5pp to quarterly growth. Employment remains weak but less so than in H2 2012.

Outlook for 2013 and 2014: the Spanish economy is expected to remain in recession during the initial quarters and, in the most likely scenario, GDP will fall -1.4% y/y in 2013, similar to the fall recorded in 2012. The outlook is brighter for 2014, when we expect the economy will pick up again (+0.9%) due to the improved international landscape, the conclusion of internal adjustment processes and a less austere fiscal policy. Nonetheless, in 2013-2014 the economy is expected to be marked by a dynamic international sector, boosted by the solid performance of sales outside Spain. Therefore, in 2013 external demand will contribute 2.5pp to growth in GDP while domestic demand will once again contribute negatively to growth (estimated at -4.5pp). In 2014, the significant drop in investment observed in recent years is expected to end, giving way to a slight improvement that will offset the downward trend in domestic demand (the estimated contribution to growth being -0.4pp); while the international sector will continue to support growth.

Outlook for inflation: following the base effect due to tax changes in H2 2012, inflation is forecast to carry on decreasing throughout 2013 and 2014. That said, there are still no signs of inflationary pressures on demand and the most recent information includes an exertion of downward pressure. Average inflation for this year is around 1.7%, slightly higher than expected for the euro zone. For 2014, the estimated rate of inflation is 1.2%.

Public sector: Spanish public authorities closed 2012 with a deficit of 7% of GDP, excluding aid for the financial sector (3.6% of GDP), which is 0.7pp above the budget target. While the nominal deficit was reduced by 2pp, the structural deficit was down around 3.9pp, standing at 3.3% of GDP. Except for the payment of interest on public debt, the adjustment to the primary structural deficit would have been over 4.4pp of GDP, which is almost the same as the budget balance (-0.3% of GDP). The government revised the deficit targets for 2013 and 2014 from 4.5% and 2.8%, respectively, to 6.3% and 5.5%. A number of measures were presented including, on the one hand, new tax rises and, with respect to expenses, the reforms already announced will remain in place. However, the fiscal adjustment policies as a whole are not expected to be sufficient enough to offset the negative effects of the fall in activity. Therefore, the deficit in 2013 will remain pegged at around 6.5% of GDP.

Box 3. Portugal: More time for fiscal adjustments, albeit with larger cuts

Economic recession could have eased at the beginning of 2013

The latest figures of forward indicators show that the economic downturn slackened off during the first quarter of 2013 and the beginning of the second quarter.

An improvement in confidence was observed in the initial months of 2013 with respect to year-end 2012. Consumer confidence continued to rise in April (to -53.6 points, 6.5 points more than the all-time low observed in October 2012), although it is still 1.5 standard deviation short of the historic average (-37.7).(Chart 23) The economic climate indicator also continued to gain ground (to 82.4 points, 6.1 points above the minimum observed in October 2012), although here again the values were 1.3 standard deviation short of the historic average (93.7 points) (Chart 23).

Business data were also more dynamic in comparison to the performances observed in 4Q12. The industrial production index rose during the first quarter by 3.7% QoQ, after a fall of 3.8% in 4Q12. Retail sales also recovered in the first quarter of 2013 (1.9% QoQ) (Chart 25).

Transferring this information to our MICA-BBVA model, we forecast that GDP will move down by 0.5% QoQ in 1Q13 to moderate the downturn after a sharp fall during the last quarter of 2012 (-1.8% QoQ) (Chart 26).

Another year of recession, albeit with smoother dips

As already reported in our last Economic Outlook for Portugal, we have now reviewed our growth forecast for 2013 to -2.3% YoY, as against the previous -1.2%. This review was chiefly due to the base effect caused by a poor economic performance at the end of 2012, and to domestic demand, which is set to take a larger fall than expected.

Our basic scenario, however, still assumes that net exports will continue to be the primary driver of growth in 2013 (net contribution of 1.6 pp to growth), although expectations in terms of exports are still fragile. We feel they will increase by an average of 0.8% YoY, down against the figures for 2012 (3.3% YoY), while imports ought to decrease by 3.4% YoY after a fall of 6.9% the previous year (Chart 27). In terms of domestic demand, fiscal consolidation and financial conditions will continue to have an adverse effect on private consumption and investment, which will continue to fall this year, albeit at an increasingly slower pace. We feel private consumption will move down by 3.3%, after a 5.6% fall in 2012, and investment will lose 8.2% after a decrease of 14.5%. Including the public sector, domestic demand will shave 3.9 points off growth in 2013, contrary to our previous forecast of -2.5 pp.

More time for fiscal adjustments…

Deficit targets have been reviewed in the wake of the Troika's seventh evaluation, and this gives the government another year (until 2015) to bring the deficit below the 3% threshold stipulated by the Stability and Growth Pact. The targets have risen from 4.5% to 5.5% of GDP for 2013, from 2.5% to 4% of GDP in 2014, and the target for 2015 has been set at 2.5%. The review was implemented following substantial compliance with the measures agreed with the Troika and a downward review of the country's growth prospects, primarily due to estimations of a poorer performance in terms of foreign demand. This is in line with the new European tendency of not overadjusting public finances when the main reason for failed compliance is an economic situation that is worse than expected.

… in exchange for new measures to meet additional financing needs

En marzo, el gobierno se comprometió a cubrir las necesidades de financiamiento adicionales tras la flexibilización de objetivos, con la presentación y adopción de su programa fiscal de medio plazo basado principalmente en la reducción de gasto público (tras los incrementos de impuestos que han sido la base del ajuste en 2013). Esto, sumado a que el tribunal constitucional derogó varios puntos de la ley del presupuesto, alegando que no son equitativos porque afectan sólo a funcionarios y pensionistas (principalmente eliminación de las pagas extras de verano para funcionarios y pensionistas), ha llevado a que el gobierno presente nuevas medidas fiscales para el periodo 2013-2015.

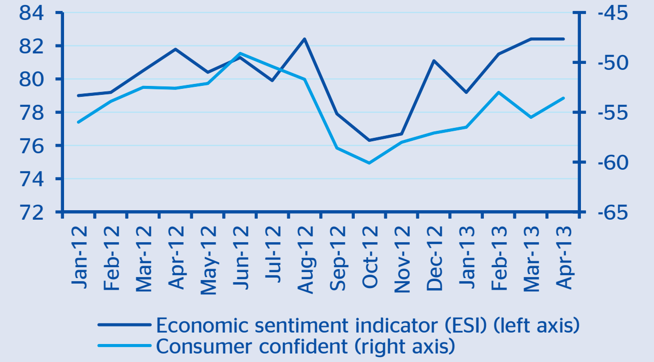
The new package intends to raise the age of retirement with no penalisation to 66 from the current 65[6], introduce longer working hours for civil servants (from 35 hours a week at present to 40), and reduce the state workforce (30,000 employees). It has been estimated that the measures could save the government approximately 4,800 million euros (3% of GDP), the sum required to reduce the country's present structural deficit to quasi-equilibrium (-0.2% of GDP), meeting the IMF's recommendations in January this year.

6: The legal age of retirement remains at 65, although in 2014 employees taking retirement at this age will not receive the full pension.

The deficit in 2012 and forecasts for 2013

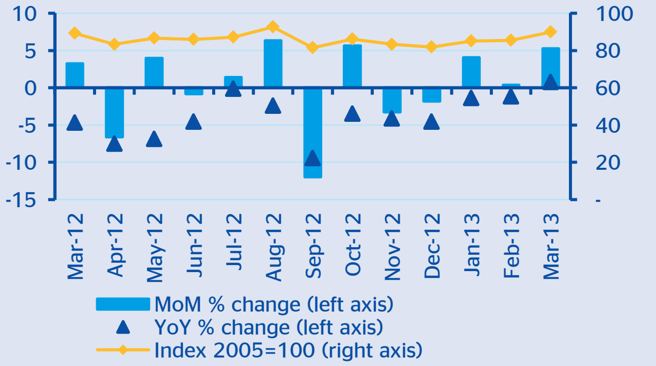
Portugal's public deficit was 6.4% of GDP at year-end 2012; including sale of the ANA airport concession and other one-off measures, this was reduced to 5.3% of GDP, around 0.3 pp higher than the latest estimates (BBVA and government, 5%). The discrepancy with the target was primarily due to a more extensive economic downturn and an increase in interest payments (+0.2 pp and +0.1 pp respectively). Our main scenario for 2013 considers the government will meet the deficit targets set (4.4% of GDP). According to our calculations, the structural adjustment required is in the region of 3.2% of GDP, which will be partially offset by an economic downturn of approximately -2.3%. The structural deficit will stand at 3.2% of GDP and structural equilibrium will be achieved around 2018, matching the calendar submitted by the Portuguese government.

Chart 23
Portugal: econmic sentiment indicator (ESI) and consumer confident



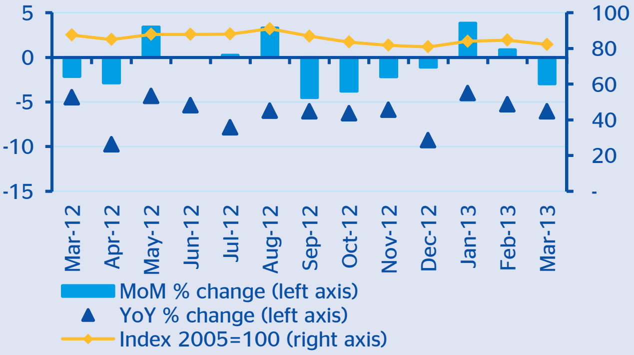
Source: Haver Analytics y BBVA Research

Chart 24
Industrial production (seasonally and working-day effect adjusted)



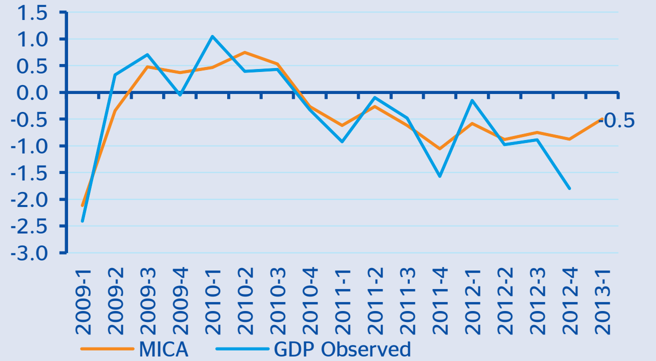
Source: Haver Analytics y BBVA Research

Chart 25
Retail sales (seasonally and working-day effect adjusted)



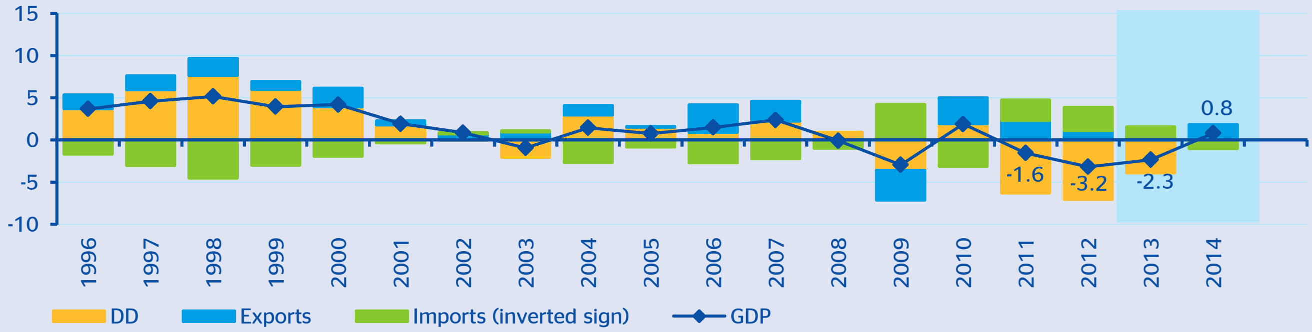
Source: Haver Analytics y BBVA Research

Chart 26
MICA y GDP observed (% q/q)



Source: Haver Analytics and BBVA Research

Chart 27
Portugal: GDP growth and contributions



Source: Haver Analytics and BBVA Research

Box 4. United Kingdom: Consolidation of the recovery in 2013, underpinned by robust domestic demand, which will gain traction in 2014

The economy recovered in 1Q13, buoyed by the improvement in the services sector…

GDP rose by 0.3% qoq in the first quarter of the year, somewhat more than expected (BBVA Research: 0.2%; Consensus: 0.1%), following the decline in 4Q12 which was due partly to the one-off boost from the Olympic Games. Furthermore, the positive reading is that this growth was underpinned by increased activity in the services sector (0.6% q/q), which represents around 75% of GVA, while industrial production inched upwards (0.2% qoq) and activity in the construction sector shrank again (-2.5% qoq), burdened by cuts in public spending.

… evidencing the resilience of domestic demand

While the GDP breakdown on the demand side has not yet been released, the indicators available for 1Q13 suggest that the robustness of domestic demand was again the main growth driver (+0.3pp), continuing the trend seen in 2012. Despite the gloomy consumer outlook and the slight deterioration in the labour market (Chart 28), retail sales increased again in the first quarter, suggesting that private consumption has bounced back to levels similar to those recorded in the second half of last year (around 0.3% qoq). Furthermore, the improvement in industrial production should have been reflected by an increase in investment, especially when companies' capacity usage is already around its historical average and in the wake of the inventory reduction process conducted in the previous quarters. Finally, the support from public consumption appears to be waning, although it has continued to contribute to growth.

With regard to the foreign sector, despite being sluggish, exports may have performed slightly better (Chart 29), shored up by the better economic performance of the Euro area (which accounts for 45% of total exports), but especially because of the recovery in the US economy (16% of the total), and the depreciation of sterling (more than 5% against the euro and around 4% against the dollar). Although imports may also have been somewhat more resilient, our projections suggest that net exports did not drain growth (0.0pp).

The indicators available for 2Q13 point to a sustained recovery, but also to fragile fundamentals…

The initial activity data for this quarter (very limited, only sentiment levels for April) suggest that the economy continued to grow, and even gained traction, in line with our scenario (0.4% qoq in 2Q13). Moreover, the composite PMI rose again, remaining amply above 50 points, and reaching levels similar to those seen in mid-2011 when the economy was growing at around that pace. The sub-indexes of that survey suggest that the trend observed early in the year will continue, with some acceleration in the services sector, while industrial production will remain almost stagnant, and with some moderation in the construction industry's decline, which could partly be reflecting taxpayer aid to the residential segment.

Nevertheless, the slight deterioration in April consumer sentiment readings, partly reflecting the increase in inflation plus the slight decline in the labour market and the recent wage moderation, coupled with gloomy expectations in the industrial sector, evidence the fragility of the fundamentals of domestic demand and, as a result, of the recovery.

… leading to more measures to shore up the recovery

On the one hand, although the government is sticking to its fiscal consolidation plan throughout its term until the 2015-16 tax year (around 8.7% of GDP since 2010-11) and it has not given way to pressures to ease fiscal consolidation, in March it presented a neutral Budget for the 2013-14 tax year by changing the pattern of this consolidation, so that this year the adjustment will be 0.7% of GDP, compared with the 1.6% previously announced. As a result, the deficit will increase by around 0.05pp to 6.8%, pushing debt up to 95.5% of GDP. Furthermore, in an effort to foster growth and support the recovery, the government unveiled an increase in capital investment to be financed through a larger cut in public spending in the last few years of the programme. Other measures were also announced, most notably the reduction in companies' employee contributions, the disappearance of the fuel tax scheduled to kick in in September, and a new programme to finance the purchase of new homes ("Help to Buy"). In the longer term, a corporate income tax cut was announced for 2015, to be paid for by raising taxes on banks.

When the Budget was unveiled, the Bank of England's mandate was also modified, to emphasise the role of monetary policy in boosting growth. The 2% inflation target was maintained, although there will be greater transparency with regard to the impact of this policy in controlling both inflation and growth. The aim is to improve communication regarding the monetary policy approach linked to intermediate goals. Accordingly, although there has not been a really significant change, the groundwork is being laid for a more active use of this tool, as the incoming governor is more amenable to such an approach.

Finally, the Funding for Lending Scheme has been extended in both duration (another year, through January 2015) and in terms of the beneficiaries of this funding, with greater weighting on SMEs, which may be channelled through other intermediaries as well as banks. However, although this programme has had an impact on the reduction of funding costs, this has not yet been clearly reflected by an improvement in lending to the private sector, evidencing that sluggish demand for credit amid the gloomy outlook of economic agents also has a part to play (Chart 31).

The resilience of private consumption and the rebound by investment are key to the recovery

Given the recovery in activity, the robustness of the labour market observed in 2012 will persist during the projection period, although the pace of job creation will ease in 2013, since an increase is expected in the working hours of part-time employees rather than an increase in the number of employees. As a result, the unemployment rate will remain relatively stable in 2013, easing slightly next year. However, we think the wage moderation observed at the end of 2012 will continue this year, and this, coupled with the inflation hike, will end up triggering less growth in real disposable household income. This, plus low consumer sentiment levels, leads us to expect a slight moderation in private consumption in 2013 (1.1%). For 2014, household consumption will increase again, to 1.5%, albeit still below pre-crisis growth levels.

These expectations of sustainability in private demand, plus public investment plans presented in the Budget and support for new home purchases will trigger another rebound in investment (around 4% in 2013 and 6% in 2014), also boosted by the projected improvement in exports. Furthermore, the extension of the FLS will continue to ease credit conditions to the private sector.

Finally, the change in the pattern of fiscal consolidation presented in the March Budget will result in almost stagnant public consumption in 2013, which will not drag on growth as we expected three months ago, although it will do so in 2014 (-0.7%).

As a consequence of the above, domestic demand will contribute 1.2pp to economic growth in 2013, and 1.7pp in 2014) (Chart 31).

Despite the weak foreign sector, the burden of net exports will fade

Following the stagnation of exports in 2012, our projections suggest that they will recover somewhat in 2013 (1.1%), underpinned by revitalised imports in the Euro area and helped by sterling's depreciation (around 8%). The latter will also impact on imports, whose growth this year will slow to 1.7% (2.7% in 2012) (Chart 31). Net exports will accordingly have a drag on GDP growth of 0.2pp (-0.9pp in 2012). In 2014, the recovery of the Euro area along with the acceleration in global demand will be evidenced by robust growth in exports, outpacing imports growth, leading to a positive contribution by net exports to growth (0.1pp) and a reduction in the current account deficit (-2.8% of GDP).

Slow recovery in 2013, gaining traction in 2014 to grow at around its potential

Considering the above, our projections envisage moderate but sustained growth (similar to that observed in 1Q13) for the rest of the year, since despite the slight decline in the fundamentals of domestic demand early in the year (slight increase in unemployment and higher inflation), they have been offset by the slight rise in consumption and public investment. As a result, we maintain our 2013 and 2014 growth forecasts at 1% and 1.9%, respectively.

Inflation will stay clearly above 2% in the projection period

Inflation climbed further in 1Q13 to 2.8% in March, somewhat higher than expected, responding mainly to the increase in the prices of the underlying component. Considering the slight increase in commodity prices plus the depreciation in sterling, we now think average annual inflation for 2013 will be 2.8%, easing throughout the second half of the year and reaching 2.2% in 2014.

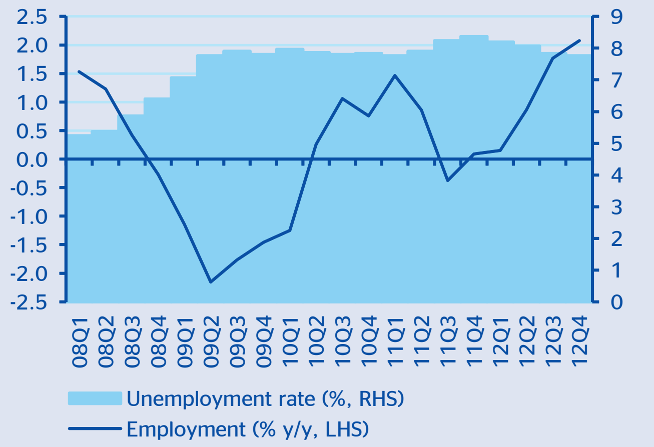
This scenario suggests that monetary policy will be maintained during the projection period

The positive surprise in quarterly GDP growth, along with the rise in 1Q13 inflation, has reduced the likelihood of extending non-standard monetary policy measures in the short term. Based on these results and given our growth and inflation scenarios, we expect the Bank of England to maintain its monetary policy approach in the next three quarters, with the benchmark interest rate at 0.5% and the asset purchase programme frozen (£375bn).

However, the change of governor in mid-July increases the probability of implementing a monetary policy that is not aimed solely at the inflation target, but also at reducing volatility in production, as evidenced by the new Bank of England mandate approved in March.

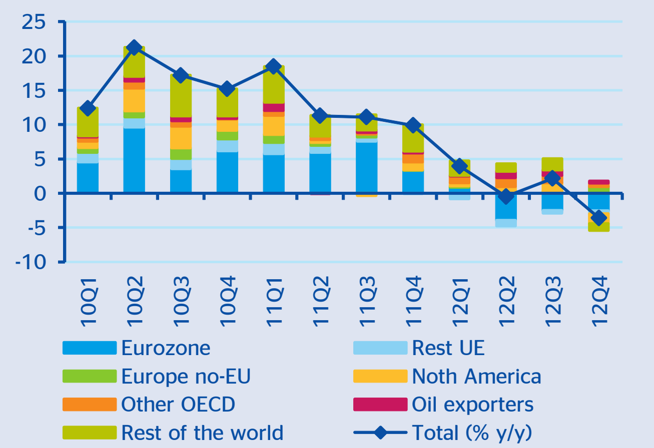
This new approach, along with greater weakness in the Euro area during the projection period, which will continue to be a source of concern for the UK authorities, makes the Bank of England more likely to delay raising the benchmark interest rate to the end of 2014 or even beyond the projection period, in contrast to what we expected three months ago (from the second quarter onwards).

Chart 28
United Kingdom: Labor market



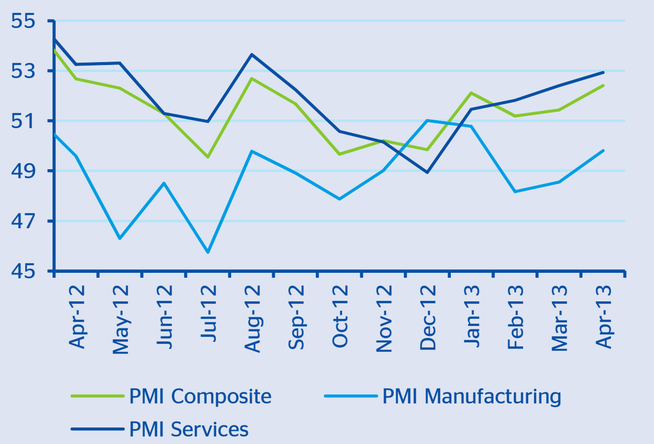
Source: ONS and BBVA Research

Chart 29
UK: Contribution to annual exports growth by destination



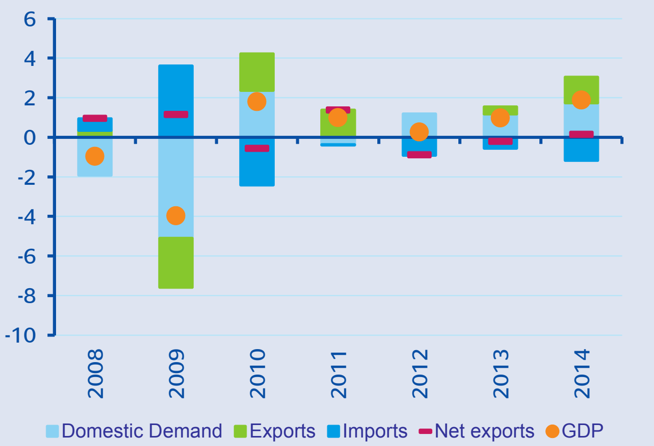
Source: ONS and BBVA Research

Chart 30
United Kingdom: PMI



Source: ONS and BBVA Research

Chart 31
United Kingdom: Annual contribution to growth (pp)



Source: ONS and BBVA Research

5. Tables

Table 1
Eurozone forecasts

(YoY)	2010	2011	2012	2013	2014
GDP at constant prices	1.9	1.5	-0.5	-0.1	1.0
Private consumption	1.0	0.1	-1.3	-0.6	0.6
Public consumption	0.8	-0.2	-0.3	-0.3	0.2
Gross Fixed Capital Formation	-0.5	1.6	-3.9	-1.6	3.2
Inventories (*)	0.6	0.2	-0.6	-0.2	0.0
Domestic Demand (*)	1.2	0.5	-2.1	-0.9	0.9
Exports (goods and services)	11.0	6.4	2.9	2.3	3.5
Imports (goods and services)	9.5	4.3	-0.8	0.8	3.7
External Demand (*)	0.7	1.0	1.6	0.7	0.1
Prices and Costs					
CPI	1.6	2.7	2.5	1.6	1.5
CPI Core	1.0	1.7	1.8	1.5	1.5
Labour Market					
Employment	-0.5	0.5	-0.7	-0.6	0.4
Unemployment rate (% of labour force)	10.1	10.2	11.4	12.2	11.8
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-6.2	-4.1	-3.7	-2.7	-2.2
Public debt (% GDP)	85.5	87.3	90.7	93.5	93.8
External Sector					
Current Account Balance (% GDP)	0.0	0.2	1.2	2.0	2.1

(*) Contribution to GDP growth
Source: BBVA Research

Table 2
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2010	2011	2012	2013	2014
United States	2.4	1.8	2.2	1.8	2.3
Eurozone	1.9	1.5	-0.5	-0.1	1.0
Germany	4.0	3.1	0.9	0.8	1.8
France	1.6	1.7	0.0	0.0	1.1
Italy	1.7	0.5	-2.4	-1.3	0.8
Spain	-0.3	0.4	-1.4	-1.4	1.1
UK	1.8	1.0	0.3	1.0	1.9
Latin America *	6.2	4.3	2.8	3.4	3.6
Mexico	5.4	3.9	3.9	3.1	3.1
Brazil	7.6	2.7	0.9	3.4	3.8
EAGLES **	8.4	6.6	5.1	5.6	6.0
Turkey	9.2	8.5	2.3	4.0	5.5
Asia Pacific	8.2	5.7	5.3	5.4	5.8
Japan	4.7	-0.6	2.1	1.7	1.7
China	10.4	9.2	7.8	8.0	8.0
Asia (exc. China)	6.7	3.4	3.6	3.8	4.3
World	5.1	3.9	3.2	3.3	3.9

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: May 7, 2013
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(Tasas interanuales, %)	2010	2011	2012	2013	2014
United States	1.6	3.1	2.1	2.1	2.2
Eurozone	1.6	2.7	2.5	1.6	1.5
Germany	1.2	2.0	2.0	1.7	1.8
France	1.5	2.1	2.0	1.4	1.5
Italy	1.5	2.8	3.0	2.0	1.7
Spain	1.8	3.2	2.4	1.7	1.2
UK	3.3	4.5	2.8	2.7	2.2
Latin America *	6.4	8.0	7.5	8.4	8.4
Mexico	4.2	3.4	4.1	3.9	3.5
Brazil	5.0	6.6	5.4	6.2	5.4
EAGLES **	5.3	6.0	4.2	4.4	4.6
Turkey	8.6	6.2	8.5	6.9	5.9
Asia Pacific	3.6	4.7	3.0	3.1	3.6
Japan	-0.7	-0.3	0.0	0.1	0.7
China	3.3	5.4	2.6	3.0	4.0
Asia (exc. China)	3.7	4.3	3.3	3.2	3.4
World	3.7	5.1	4.1	3.9	4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: May 7, 2013
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Current Account (% GDP)

	2010	2011	2012	2013	2014
United States	-3.1	-3.1	-3.1	-3.0	-3.5
Eurozone	0.0	0.1	1.2	2.0	2.1
Germany	6.0	5.7	7.0	6.0	5.5
France	-1.6	-2.0	-2.3	-1.6	-1.5
Italy	-3.5	-3.1	-0.7	0.1	0.0
Spain	-4.5	-3.7	-1.1	0.5	1.0
UK	-3.9	-1.6	-4.6	-3.0	-2.8
Latin America *	-0.6	-0.8	-1.4	-1.7	-1.9
Mexico	-0.1	-0.8	-0.7	-1.1	-1.4
Brazil	-2.2	-2.1	-2.4	-3.0	-3.3
EAGLES **	1.6	0.5	0.4	0.4	0.6
Turkey	-6.4	-10.0	-5.9	-6.5	-6.8
Asia Pacific	3.3	1.6	1.2	1.4	1.8
Japan	3.6	2.3	1.7	1.5	1.7
China	4.0	1.9	2.3	2.8	3.5
Asia (exc. China)	2.0	1.4	0.4	0.4	0.6

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: May 7, 2013
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Government Deficit (% GDP)

	2010	2011	2012	2013	2014
United States	-8.9	-8.7	-7.0	-5.4	-3.8
Eurozone	-6.2	-4.1	-3.7	-2.7	-2.2
Germany	-4.1	-0.8	0.2	-0.5	0.0
France	-7.1	-5.3	-4.8	-3.8	-3.0
Italy	-4.3	-3.8	-2.8	-2.9	-1.8
Spain *	-9.7	-9.0	-7.0	-6.5	-5.7
UK	-10.2	-7.8	-6.3	-6.8	-5.7
Latin America **	-2.5	-2.3	-2.6	-2.2	-2.2
Mexico	-3.4	-2.6	-2.8	-2.4	-2.3
Brazil	-2.5	-2.6	-3.0	-2.3	-2.5
EAGLES ****	-2.8	-1.9	-2.1	-2.2	-2.1
Turkey	-3.6	-1.4	-2.1	-1.9	-1.1
Asia Pacific	-3.6	-3.7	-3.5	-3.7	-3.2
Japan	-9.5	-10.0	-9.5	-10.0	-8.0
China	-2.5	-1.1	-1.6	-2.0	-1.8
Asia (exc. China)	-4.5	-5.4	4.8	4.9	-4.1

* Excluding aid to financial sector
** Fiscal year from 1 April to 31 March
*** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
**** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: May 7, 2013
Source: BBVA Research

Table 6

Financial Variables

Official Interest Rates (End period)	2010	2011	2012	2013	2014
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	0.75	0.75	0.75
China	5.81	6.56	5.75	6.00	6.50
10-year Interest Rates (Avg.)					
United States	3.2	2.8	1.8	2.0	2.6
EMU	2.8	2.6	1.6	2.0	2.9
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.76	0.72	0.78	0.77	0.77
EMU	1.33	1.39	1.29	1.30	1.30
UK	0.65	0.62	0.63	0.67	0.68
Japan	87.8	79.7	79.8	101.1	112.9
China (RMB per USD)	6.77	6.46	6.31	6.18	6.02

Forecast closing date: May 7, 2013
Source: BBVA Research

Table 7

Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	0.6	0.3	0.8	1.7	0.6	0.8	1.2
Public consumption	3.2	3.0	1.7	1.0	1.4	0.9	1.1
Gross Fixed Capital Formation	0.6	-11.5	5.6	6.4	-1.9	0.6	4.4
Inventories (*)	-0.1	-0.8	0.6	0.2	-0.6	0.0	0.0
Domestic Demand (*)	**0.9**	**-2.2**	**2.4**	**2.4**	**-0.3**	**0.7**	**1.7**
Export	2.3	-12.8	13.4	7.9	4.3	2.7	5.2
Import	3.0	-8.0	10.9	7.5	2.2	3.0	5.8
Net export (*)	**-0.1**	**-2.9**	**1.6**	**0.6**	**1.2**	**0.0**	**0.1**
GDP	**0.8**	**-5.1**	**4.0**	**3.1**	**0.9**	**0.8**	**1.8**
Inflation	**2.8**	**0.2**	**1.2**	**2.5**	**2.1**	**1.7**	**1.8**

(*) Contribution to growth
Source: BBVA Research

Table 8

France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	0.2	0.3	1.5	0.3	-0.1	-0.1	0.9
Public consumption	1.2	2.6	1.7	0.2	1.4	0.5	0.6
Gross Fixed Capital Formation	0.1	-10.4	1.0	3.5	0.0	-1.4	1.8
Inventories (*)	0.3	-1.3	0.1	0.9	-1.0	0.0	0.0
Domestic Demand (*)	**0.2**	**-2.6**	**1.6**	**1.7**	**-0.7**	**-0.3**	**1.0**
Export	-0.6	-11.8	9.2	5.5	2.5	1.8	4.1
Import	0.6	-9.5	8.4	5.2	-0.3	0.7	3.5
Net export (*)	**-0.4**	**-0.5**	**0.0**	**0.0**	**0.8**	**0.3**	**0.1**
GDP	**-0.2**	**-3.1**	**1.6**	**1.7**	**0.0**	**0.0**	**1.1**
Inflation	**3.2**	**0.1**	**1.7**	**2.3**	**2.2**	**1.4**	**1.5**

(*) Contribution to growth
Source: BBVA Research

Table 9

Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	-0.8	-1.6	1.5	0.1	-4.3	-2.3	0.1
Public consumption	0.6	0.8	-0.4	-1.2	-2.9	-1.5	-0.5
Gross Fixed Capital Formation	-3.8	-11.7	0.5	-1.4	-8.0	-3.8	2.7
Inventories (*)	0.0	-1.1	1.1	-0.5	-0.6	0.0	0.0
Domestic Demand (*)	**-1.2**	**-4.3**	**2.1**	**-1.0**	**-5.2**	**-2.4**	**0.4**
Export	-2.8	-17.7	11.2	6.6	2.2	2.2	3.9
Import	-2.9	-13.6	12.3	1.1	-7.8	-1.5	3.2
Net export (*)	**0.0**	**-1.2**	**-0.4**	**1.5**	**2.8**	**1.1**	**0.4**
GDP	**-1.2**	**-5.5**	**1.7**	**0.5**	**-2.4**	**-1.3**	**0.8**
Inflation	**3.5**	**0.8**	**1.6**	**2.9**	**3.3**	**2.0**	**1.7**

(*) Contribution to growth
Source: BBVA Research

Table 10

Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	1.3	-2.3	2.5	-3.8	-5.6	-3.3	0.1
Public consumption	0.3	4.7	0.1	-4.3	-4.4	-2.4	-1.4
Gross Fixed Capital Formation	-0.3	-8.6	-3.1	-10.7	-14.5	-8.2	3.7
Inventories (*)	0.0	-1.1	0.9	-0.7	0.2	0.0	0.0
Domestic Demand (*)	**0.9**	**-3.6**	**2.0**	**-6.3**	**-7.0**	**-3.9**	**0.3**
Export	-0.1	-10.9	10.2	7.2	3.3	0.8	4.0
Import	2.3	-10.0	8.0	-5.9	-6.9	-3.4	2.8
Net export (*)	**-1.0**	**0.6**	**-0.1**	**4.7**	**3.9**	**1.6**	**0.5**
GDP	**-0.1**	**-2.9**	**1.9**	**-1.6**	**-3.2**	**-2.3**	**0.8**
Inflation	**2.7**	**-0.9**	**1.4**	**3.6**	**2.8**	**0.7**	**1.0**

(*) Contribution to growth
Source: BBVA Research

Table 11

Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	**-0.6**	**-3.8**	**0.7**	**-1.0**	**-2.1**	**-3.0**	**-0.5**
Public consumption	5.9	3.7	1.5	-0.5	-3.7	-5.1	-1.8
Gross Fixed Capital Formation	-4.7	-18.0	-6.2	-5.3	-9.1	-8.5	1.3
Equipment and other products	-2.9	-23.9	2.6	2.3	-6.6	-4.7	4.9
Construction	-5.8	-16.6	-9.8	-9.0	-11.5	-10.9	-1.0
Housing	-9.1	-23.1	-10.1	-6.7	-8.0	-9.3	0.8
Other construction	-1.6	-9.1	-9.6	-11.0	-14.6	-12.4	-2.7
Inventories (*)	0.1	0.0	0.1	-0.1	0.1	0.0	0.0
Domestic Demand (*)	**-0.5**	**-6.6**	**-0.6**	**-1.9**	**-3.9**	**-4.5**	**-0.4**
Export	-1.0	-10.0	11.3	7.6	3.1	4.7	6.4
Import	-5.2	-17.2	9.2	-0.9	-5.0	-4.9	2.8
Net export (*)	**1.4**	**2.9**	**0.3**	**2.3**	**2.5**	**3.0**	**1.4**
GDP	**0.9**	**-3.7**	**-0.3**	**0.4**	**-1.4**	**-1.4**	**0.9**
Inflation	**4.1**	**-0.3**	**1.8**	**3.2**	**2.4**	**1.7**	**1.2**

(*) Contribution to growth
Source: BBVA Research

Table 12

UK: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	-1.6	-3.1	1.3	-0.8	1.2	1.1	1.5
Public consumption	1.6	0.8	0.4	-0.3	2.2	0.3	-0.7
Gross Fixed Capital Formation	-4.6	-13.7	3.5	-2.9	1.5	4.2	6.1
Inventories (*)	-0.4	-1.0	0.9	0.5	-0.3	0.0	0.0
Domestic Demand (*)	**-1.9**	**-5.1**	**2.4**	**-0.4**	**1.2**	**1.2**	**1.7**
Export	1.2	-8.2	6.4	4.5	-0.2	1.1	4.2
Import	-1.8	-11.0	8.0	0.0	2.7	1.7	3.5
Net export (*)	**0.9**	**1.1**	**-0.6**	**1.4**	**-0.9**	**-0.2**	**0.1**
GDP	**-1.0**	**-4.0**	**1.8**	**1.0**	**0.3**	**1.0**	**1.9**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.7**	**2.2**

(*) Contribution to growth
Source: BBVA Research

This report has been produced by the Europe Unit:

Chief Ecnomist for Developed Economies
Rafael Doménech
+34 91 537 36 72
r.domenech@grupobbva.com

Europe
Miguel Jiménez
+34 91 537 37 76
mjimenezg@bbva.com

Agustín García Serrador
+34 91 374 79 38
agustin.garcia@bbva.com

Sonia López Senra
Sonia.lopez.senra@bbva.com
+34 91 537 79 36

Diego Torres Torres
diego.torres.torres@bbva.com
+34 91 374 05 12

With the contribution of:

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com
+34 91 374 44 32

María Martínez Álvarez
maria.martinez.alvarez@bbva.com
+34 91 537 66 83

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Macroeconomic Analysis Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Contact details:

BBVA Research
Paseo Castellana, 81 - 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com