

EuropaWatch

November 2009

Economic Research Department



The European economy has bottomed out, but the recovery will be sluggish

Once the fiscal stimulus wanes, the sustainability of domestic demand is uncertain, so ...

... exit strategies from monetary and fiscal policies have to be implemented with caution

Interest rates will remain very low for longer than is broadly expected

Contents

Closing date: November 24th 2009

1. Editorial	2
2. The global economy stabilizes, but risks remain	3
3. Perspectives for the Eurozone economy	6
Box 1. Fiscal policy: Too early to tighten	12
Box 2. On the effectiveness of vehicle scrapping schemes and their impact on consumption	14
Box 3. The euro area banking system: No room for complacency	16
Box 4. United Kingdom: The British patient	18
Box 5. Potential Output: Lower growth after the downturn	21
4. The determinants of European Inflation: An assessment of the role of macroeconomic variables and institutions	23
5. The Lisbon Treaty: A fresh start for Europe?	30
6. Summary of Forecasts	34

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1. Editorial

Several months after the fallout, the European economy has started to recover, although it remains weak. Those green shoots that started to be seen last spring have materialized in positive growth in the third quarter of the year, although GDP is still 5 points below its pre-crisis level. The recovery will be hesitant and slower than in the US.

Thanks to the resilience of emerging economies, exports have been behind this timid recovery in a similar way as they were partly responsible for the slump in activity during the last quarter of 2008 and the first one of this year. But a good part of the growth we have seen so far can be also explained by the fiscal stimulus put in place in an unusually coordinated way at the beginning of 2009. To a large extent, this positive effect was expected. When those plans were approved, and despite the uncertainty that is usually attached to the impact of fiscal policies, we were projecting a sizeable push on GDP for the second half of the year and perhaps the beginning of 2010. This has proven to be the case. Of the myriad of measures taken by different countries, it was difficult to say which were going to be more useful in sustaining activity. So far it seems that those measures that support the automobile industry and those that help to maintain employment have been the most successful, although probably many of the rest of fiscal plans are also helping in a less visible way. However, once these policies are progressively withdrawn, there are reasonable doubts about the capacity of private demand to take the lead. This is one source of uncertainty for the coming quarters.

The other element of weakness rests in the finance sector. Much of the tensions that appeared in the summer of 2007 and reignited in October 2008 have eased back, but they have not disappeared. Moreover, the banking sector in Europe has barely been restructured since the crisis started, in contrast to the US banking system where losses have been recognized and recapitalization has been addressed to a larger extent. Credit in the Eurozone is not growing, and the lack of reforms in European banks may delay the recovery once domestic demand becomes stronger again.

Despite these weaknesses, there is much talk about the exit strategies in Europe, both for monetary and fiscal policy. Monetary policy has been adequately expansive for more than one year now, with the ECB reducing official rates down to 1% (albeit after briefly raising them in the summer of 2008) and generously providing liquidity to financial institutions in order to ease financial tensions. The strategy has succeeded in reducing spreads and lifting confidence –here also the coordinated action with other central banks has been important– but now the ECB is ruminating how and when to retire the extra liquidity injected. Although the central bank is being very cautious against excessively optimistic views on the European recovery, it is also worried about the impact that narrow money aggregates may have on future inflation. This is misleading, in our view, given the fragility of the financial sector and the inflation outlook. Inflation is very low and core inflation is decelerating, standing now at 1%. With very large spare capacity –the output gap is very wide independently from the method used to calculate it– deflation risks have not completely disappeared, and it would be wise to delay the implementation of the exit strategy until the recovery gains momentum. Regarding official interest rates, and for all these reasons, we think they will remain very low for a protracted period of time, especially now that the euro exchange rate is high and the US Federal Reserve has announced that it will maintain low rates for quite a while.

As for fiscal policy, public deficit and debt ratios have shot up during the last year, and it is as important to design a decisive exit strategy for the coming years as to apply it in a timely manner, i.e., not too early. The ideal strategy would be to announce in advance a coherent set of measures in order to reduce public deficits to sustainable levels once the situation improves and to implement these measures before monetary policy starts to become tighter. There seems to be a consensus in Europe to wait until 2011 to start implementing the adjustment; however, it is not so clear the determination to return to fiscal rectitude once the adjustment starts.

All in all, the outlook for next year remains weak in Europe. After falling about 4% in 2009, GDP will barely grow in 2010 (0.2%), in a convergence path to a potential growth of close to 1.5%. The risk is that Europe remains very weak for several years if the financial sector does not reform itself swiftly. The lessons of Japan in the nineties should not be forgotten. Even if the recovery takes hold, the growth potential of Europe will be below pre-crisis levels. Not only the boom years were artificially boosted by bubbles in several markets, but also production factors will grow more slowly (the labour force due to weaker demographic dynamics and physical capital due to the fall in investment). After the crisis, the negative gap of trend growth between the Europe and the US (not to mention emerging markets) will persist.

2. The global economy stabilizes, but risks remain

Global economic activity has stabilized and the recovery has begun, but downside risks remain, especially in developed economies

The global economy has entered a more positive phase since the last publication of the Europa Watch report. The free fall in economic activity has fortunately moderated, and in the second half of 2009 most economies have stabilized or, in some cases, attained positive growth rates.

This reversal is explained to a large extent by the success of exceptional stimulus measures adopted on a global scale, both in the monetary and fiscal front. Official rates have come down substantially in the vast majority of countries and a wide range of non-conventional measures – exceptional liquidity injections and asset purchases– has allowed a partial restoration of liquidity/credit conditions. As regards fiscal policy, large stimulus packages approved in the last quarter of 2008 have gradually come into effect during 2009. These programs have allowed a remarkable impulse to key sectors –the automotive sector being a very significant case– and a positive boost to households' income, which has helped containing a more brusque adjustment in private consumption.

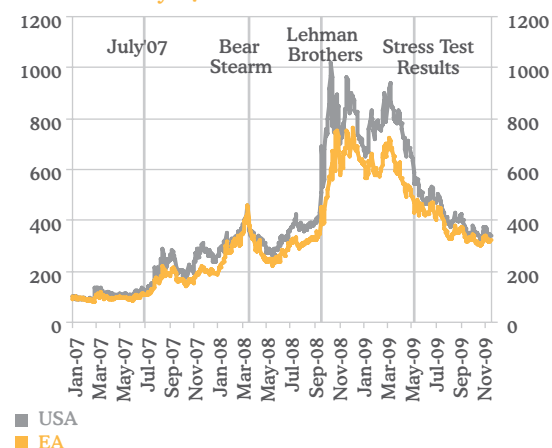
Given the role played by economic policies in stabilization, the main risk for the global economy in the short-term lies in the appropriate timing and design of the unwinding of these measures. Doubts remain about whether private demand can take the lead as the driver of the recovery, once these stimuli are withdrawn. A complete restoration in the growth of internal demand, which was the main driver of activity in the previous expansion, is unlikely to occur, for several reasons. First, a very important factor in the strength of demand was excessive recourse to debt, a feature that is highly improbable in coming years, which will be dominated by deleveraging pressures. Also, the expected evolution of labour markets, where job destruction is still very significant, will also act as a brake on private expenditure. A premature withdrawal of stimulus, particularly monetary support, could reactivate the circuit between activity contraction and financial losses and increase the duration of the recession.

Financial markets improve on the back of a recovery in risk appetite and ample liquidity

Substantial advances in the stabilization of financial markets have also occurred during 2009. After a very convulse first quarter, the publication of stress test results for US banks acted as a positive catalyst. The transparency and credibility of this supervisory exercise helped to dispel fears of a complete collapse of the banking system, accelerated the injection of public and private capital into financial institutions and, as a consequence, fostered a gradual increase in risk appetite in markets (Chart 2.1 and 2.2). Simultaneously, the liquidity injections pursued by the main central banks have been highly successful in containing tensions in interbank markets. This is the area where correction has proceeded faster and OIS spreads now stand very close to their pre-crisis levels. This evolution, however, remains strongly dependent on the support afforded by central banks, and a premature withdrawal could result in a reversion of previous gains.

Chart 2.1.
Financial tensions indicator

100 = January-07



Source: BBVA-ERD

First normalized principal component of the following series: OIS spread, implicit volatility, and banking and corporate CDS spread

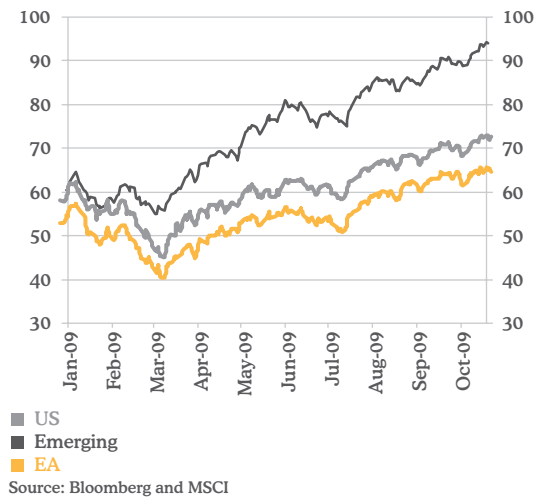
Chart 2.2.
Corporate risk index: Non-financial
5 yr CDS

(bp)



Source: Datastream

Chart 2.3.
USA, EA and Emerging Economies:
Equity markets
 (July 2007=100)

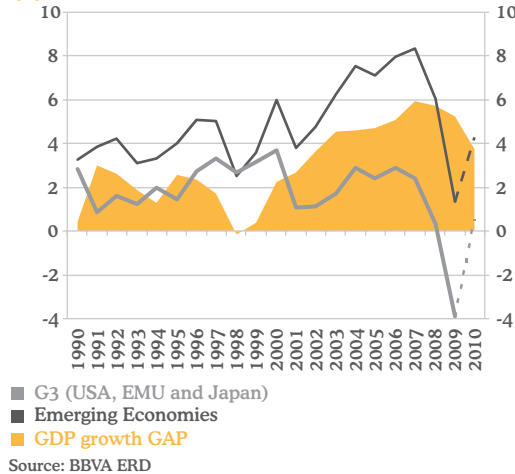


Trends in other markets have been positive too for most asset classes. Stock markets experienced strong gains from the lows reached in March (Chart 2.3), which were initially driven by financial institutions' stocks and then became more widespread as the first signs of stabilization in activity began to emerge. Credit market spreads improved markedly in the second quarter, but this trend has lost steam since the summer. In fixed income, yields of sovereign debt have shown a remarkable upward resilience, despite the positive evolution of more risky investments. This pattern is mostly explained by the expectation that official rates will remain very low for a protracted period. Also, despite very low short-term interest rates, market participants remain concerned about the foundations of the ongoing recovery and these concerns have kept risk aversion still high by historical standards. Both factors have facilitated the absorption of record high volumes of sovereign debt with limited pressures on long yields.

Emerging economies become the main driver of global growth...

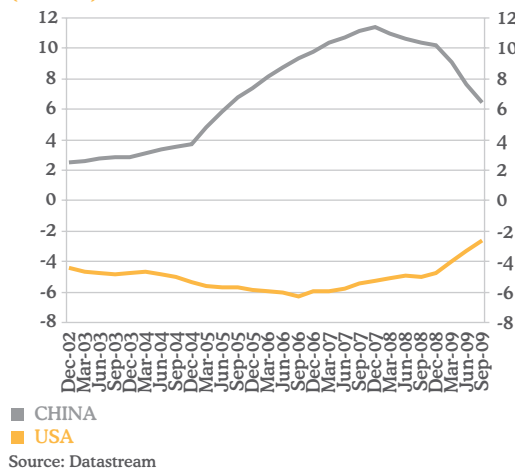
After a highly synchronized fall in activity in the later part of 2008 and the beginning of 2009, the ongoing recovery is highly heterogeneous across regions. Emerging markets' economic activity is clearly on a stronger path, a situation that is explained by the combination of several factors. Most of these countries were less exposed to the causes that originated the financial crisis. Also, they were able to use their monetary and fiscal policies to counteract the negative pressure on demand, and they did so to an extent that had not been possible in previous crisis episodes. This impulse has lately been reinforced by the gradual recovery in global trade and commodity prices in the second half of 2009. All these factors were to a large extent a direct consequence of previous efforts by emerging markets to implement sound economic policies aimed at macroeconomic stability. The continuation of these factors in 2010 makes it likely that the growth gap between developed and emerging markets widens in the future (Chart 2.4).

Chart 2.4.
Emerging economies and G3:
GDP growth
 (y/y %)



Among emerging markets, the indications of a recovery in economic activity are by now very clear, but not to the same extent in every region. The Chinese economy managed to show impressive growth in the third quarter (8,9% yoy) after a massive stimulus –implemented through rapid increases in bank lending and fiscal expenditure–. Other Asian economies are experiencing significant recoveries in the pace of activity, even if not as fast as the turnaround in China. Most Latin American countries are also back on positive growth, and a further acceleration is likely in 2010. Eastern European countries, however, face a more complicated situation. The depth of activity adjustment has been generally larger, and the existence of significant financial and macroeconomic imbalances before the crisis complicates the adoption of economic policies to alleviate it.

Chart 2.5.
USA and China: Current account
 (% GDP)



The US economy experienced positive growth in the third quarter of 2009 (+0,9% qoq), partially helped by the positive contribution of the "cash-for-clunkers" automobile support program. Some of these temporary factors will disappear gradually during 2010, but looking forward the US economy could experience a somewhat faster recovery. Support from fiscal policy will still be substantial in 2010 –estimated at 3pp for the whole year–. The restructuring of the US banking system is also proceeding at a fast pace, with several banks having already paid back the government support received.

...but the challenge posed by global current account imbalances and fiscal consolidation remains to be solved

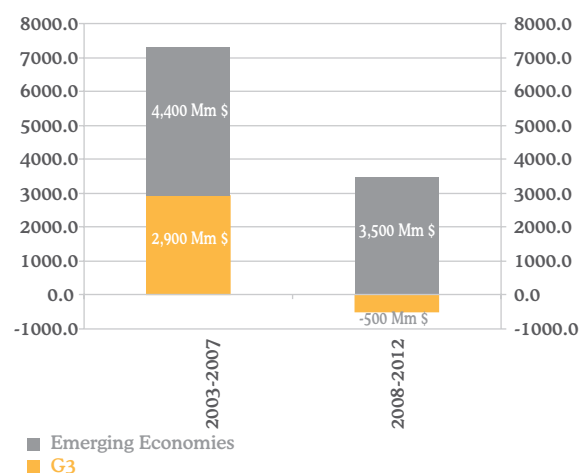
Looking forward, the continuation of growth hinges on attaining a successful rebalancing of saving and investment patterns, both at the global and domestic levels. In particular, the trends that resulted in accumulation of very large external imbalances should be reversed if the ongoing recovery is to transform into a period of sustained growth (Chart 2.5). Towards this end, private consumption should accelerate in those economies with large external surpluses, whose growth has been based on depreciated exchange rates, reserve accumulation and high saving rates. This process involves difficult challenges, particularly as regards avoiding a brusque realignment of exchange rates. On the other side, the US and other developed economies will have to adjust their saving upwards, a process that has already started but whose continuation is still uncertain (Chart 2.6).

Finally, over the medium term it will become increasingly necessary to engage in credible plans for fiscal consolidation. Otherwise, the risks of public demand crowding out private investment will clearly resurface. While the application of these plans is not necessarily warranted in current conditions, much could be gained by starting their discussion as soon as possible.

Chart 2.6.

G3 and Emerging Economies: Demand shift*

(Mm \$, 2008 prices)



(*): Private consumption + Gross Investment
Source: BBVA ERD

Chart 3.1.
GDP 2007-2010
(Index, T=100; T=2008 Q2)

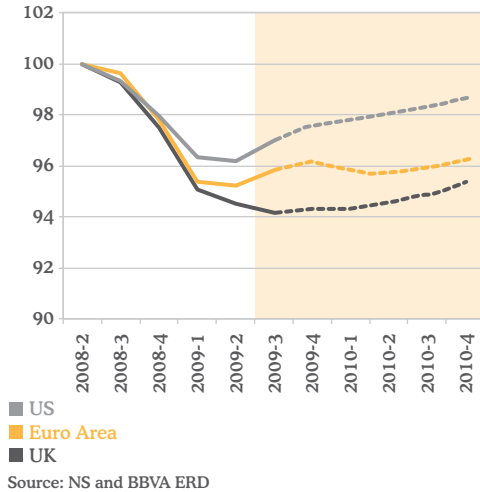


Chart 3.2.
Euro area: GDP cycles
(Index, T=100; T=start of recession)

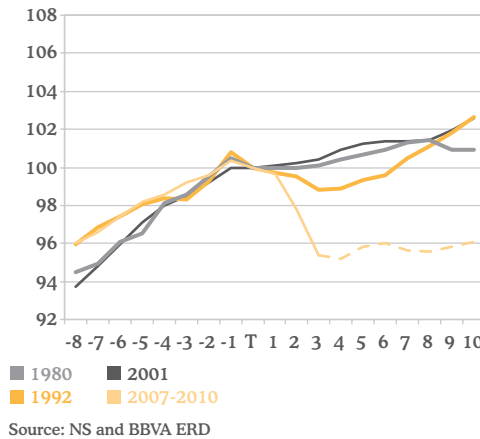
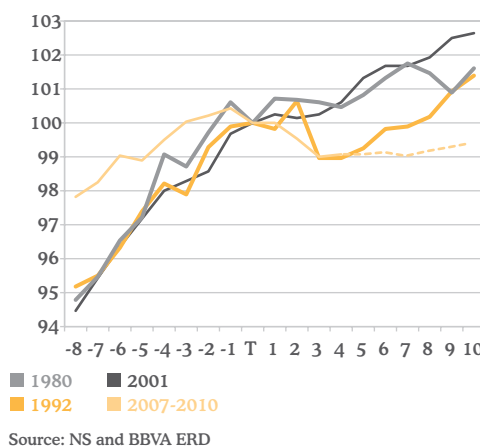


Chart 3.3.
Euro area: Private consumption cycles
(Index, T=100; T=start of recession)



3. Perspectives for the Eurozone economy

3.1 Fiscal policy is delivering and activity has recovered, but fundamentals remain weak

The contraction of the European economy has been somewhat deeper than that of the US as the fallout of external demand has been larger than in previous recessions

After the start of the subprime crisis in the US in the summer of 2007 it was not unusual to read that since the financial crisis was originated in the US it was going to affect mostly the US economy, with a minor impact on Europe. Several quarters later, especially after the Lehman Brothers episode that reignited the crisis, it was clear that this was not the case. Subsequently, the European economy was hit hard by the fall in world confidence and trade, as well as by the extreme degree of risk aversion prevalent at the end of 2008.

Chart 3.1 illustrates this point. Due in part to its higher openness to international trade, the fall in GDP in the period between the summer of 2008 and March 2009 was deeper in the euro area (EA) than in the US. The fallout has also been more profound in this crisis than in all previous recessions during the last 30 years (Chart 3.2). The recovery is also expected to be slower.

Among demand components, this recession has hit hard private consumption, as hard as in the early nineties (Chart 3.3); but this impact has not been as evident in the EA as in the US or especially the UK (Chart 3.4), where the cumulated debt of households during the boom years were higher, and the savings rates lower (Chart 3.5 and Chart 3.6). In the EA the impact of consumption has been channelled mostly through a confidence shock, together with income and unemployment uncertainty. Households have started to save rapidly in recent quarters in anglosaxon countries, but only since the second quarter of this year in the EA as a whole. For the coming quarters it is expected that the savings rate increases further, delaying the recovery of private demand.

Rather than private consumption, the main difference of this recession with previous ones lies in the dramatic fall in exports after the summer of 2008, which has pulled down investment demand and industrial production. Exports have only recently started to recover, but are still 20% percent below their pre-crisis levels (Chart 3.7).

Across countries output losses have been generalized, with small differences in the rhythm of falls and recoveries. For the Eurozone as a whole, growth has returned in the third quarter

Eurozone GDP rose by 0.4% quarterly in Q3 2009, being the first quarter of growth after 2008 Q2. Since then the cumulated fall in production levels has been of almost 5%. Among large EA countries, GDP has fallen the most in Germany and Italy, which are more dependent on international demand. In both of them GDP has started to recover marginally. Although the demand decomposition of growth in Q3 has not been published yet, it seems that exports are the main component behind this recovery.

France has withstood somewhat better the recession, in part because of less dependence of foreign demand, and also because of the absence of a construction boom as the one in countries such as Spain, Ireland or, to a lesser extent, the UK. In Spain the initial fall was smaller, probably because one of the drivers of the recession is the construction sector, with a slower transmission from demand to final production. For the same reason, Spain's GDP continued to fall in the third quarter, as it did in the UK, where a lower dependency on industrial production and

exports was compensated by weaker consumption due to high previous levels of leverage for households.

Recent indicators of confidence have been positive, but those on real activity are still mixed.

Confidence indices from the European Commission and Purchasing Managers Indices (PMI) paint roughly the same story: after March they started to recover from deep bottom levels (Charts 3.8 and 3.9), together with the bottoming out of stock markets and other financial indicators after the publication of results from stress tests in the US. The progress has been rapid in the first months and somewhat slower during the summer and after. EC confidence figures bottomed out after March 2009, while PMIs crossed the line that separates expansion from contraction more recently, in October. This improvement has been more or less simultaneous across major countries.

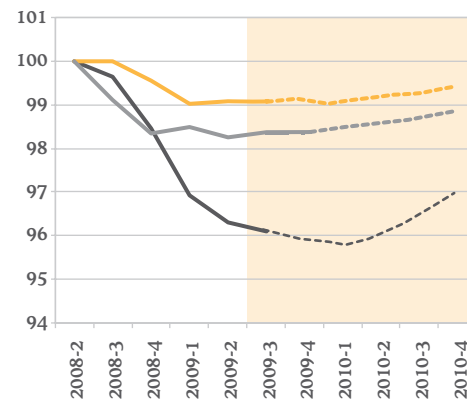
The translation of this improvement to activity indicators was hesitant at the beginning, but more convincing in the summer, although not with the strength of past episodes of recovery after deep recessions, which were more clearly characterised by strong V shapes in many indicators. Industrial production grew by 2.2% in Q3 (after having fallen by 18% since mid- 2008), while industrial new orders are growing fast. Retail sales, on the contrary, have been disappointing, and are still falling in monthly terms, confirming the dim outlook for consumption outlined above (Chart 3.10)

Apart from exports, stimulus from economic policies has been essential for stabilizing the economy

The increase of tensions in financial markets after the Lehman Brothers episode gave way to a response of economic policy that tried to prevent the risk of a deep depression in the World economy, at a time when most economic indicators were falling sharply. Central banks reacted first by cutting interest rates to levels close to zero (to 1% for the *refi* rate in the case of the ECB) and afterwards by expanding their balance sheets through the implementation of quantitative easing measures or, as the ECB puts it, non-conventional measures. In the case of the Eurozone, the ECB implemented long-term liquidity auctions and provided unlimited funds, meeting all the amount of money demanded by financial institutions at a fixed price. As a complement, the ECB also planned an intervention in the covered bonds market through the purchase of € 60 bn. This intervention (especially the direct provision of liquidity) has permitted the reduction in money market spreads and has resulted in an overnight interest rate staying the official *repo* rate and close to the deposit rate (the one at which banks hold their reserves in the central bank). It has also allowed banks to finance themselves at a time when other sources of finance were closed or extremely expensive. The effect on the real economy is difficult to estimate but has been crucial, as it has allowed banks in a difficult situation to maintain their activity and to continue channelling funds to the private sector.

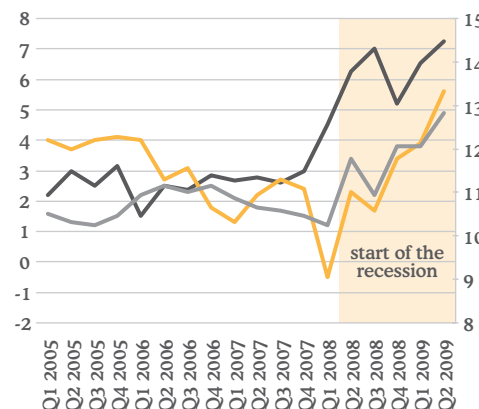
On top of the reaction of monetary policy, there was also a coordinated response of fiscal policy at a global level which was designed at the end of 2008 and already evaluated on a preliminary basis in our latest Europa Watch of December of that year. The reaction is extraordinary because of the magnitude and the degree of coordination, although its implementation within Europe has been uneven in time and relative efforts across countries (see Box 1). Overall, the size of the stimulus approved in Europe was large, approximately 1.4% of GDP, although well below the response of the US or the Chinese governments (2.1% and 6.5%, respectively; the calculations are difficult to make as it is not always obvious to separate new measures from those which were already planned but are disguised as new stimulus; the actual split of measures across time is not easy to discern either). Across countries, Germany approved the largest fiscal package (after some months of

Chart 3.4.
Consumption 2007-2010
(Index, T=100; T=2008 Q2)



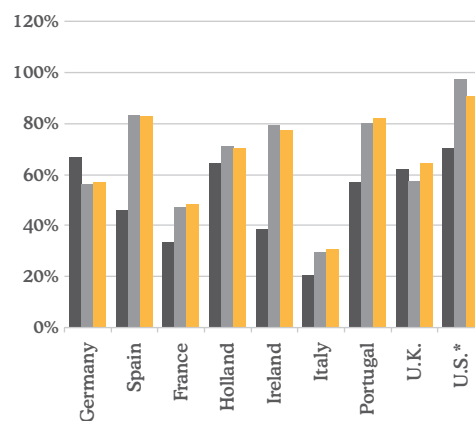
■ US
■ Euro Area
■ UK
Source: NS and BBVA ERD

Chart 3.5.
Household Savings Ratio
as % of Disposable Income



■ USA (left)
■ UK (left)
■ EMU (right axis)
Source: ECB, BoE and FED

Chart 3.6.
Household credit (% of GDP)

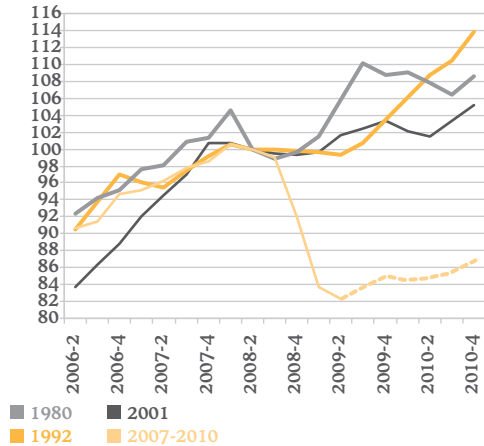


■ 2000
■ 2008
■ Sep-09
Source: BBVA ERD
*As of June-2009

Chart 3.7.

Euro area: Exports cycles

(Index, T=100; T=2008 Q2)

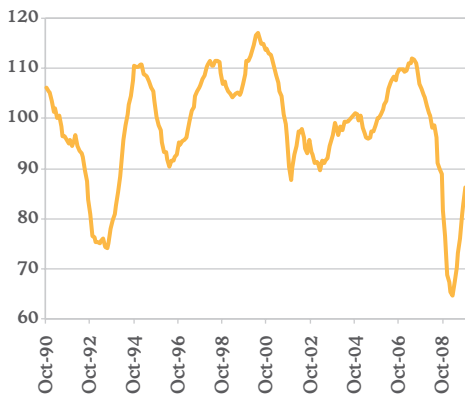


Source: NS and BBVA ERD

Chart 3.8.

Eurozone: Economic sentiment indicator

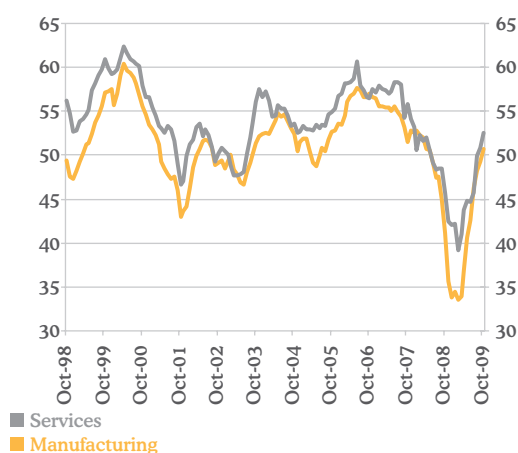
(EC survey)



Source: European Commission Survey

Chart 3.9.

Euro Area: PMI survey



Source: NTC Economics Ltd

doubts on the need and usefulness of fiscal activism), while France and Spain also had an important but lower response and Italy could barely approve new funds due to its high ratio of debt over GDP (see the referred box for details).

One year ago we estimated a fiscal multiplier of public spending in investment projects of around 1.2 percent, while we conjectured that the elasticity of GDP to other fiscal measures (tax and transfers) would be much lower, of about 0.4. With these results in mind, we projected that the euro area economy would recover in the second half of this year, although only temporary as the impact would wane afterwards. Essentially, we maintain that view. The effect of fiscal policy is difficult to estimate even now, since the information about the implementation of different programs is scarce and comes with a long delay, and in any case it would be difficult to identify its effects and separate them from other forces shaping the economy. The evolution of the recovery, however, broadly fits with our view from a year ago, although 2009 will turn out worse than expected.

Two particular measures have been cost effective in stimulating demand: Car subsidies and employment support

Of all the fiscal measures put into place, two have been especially cost effective (in the strict sense that they have probably boosted activity very strongly as compared to its budgetary cost relative to other measures approved in fiscal packages): Plans to encouraging the demand for car purchases, which have been implemented in many European countries, and measures to support employment, especially those that help firms to avoid dismissals and encourage them to reduce hours worked. In the first case, the boost of demand has been obvious, and has substituted for the lack of confidence or finance, hence avoiding a large decrease in car sales. In Germany, where the aid was larger and has been more effective, demand for cars has even surpassed trend sales by a while, which implies that part of this demand is advanced and it will not only disappear in the months to come (the German scheme has already expired), but demand will also be below trend for some time (see Box 2).

In the case of employment measures, most have been of a limited scale and with unknown effect, but one –the strengthening of the jobs share scheme, again in Germany- has had a sizeable effect on unemployment, which has increased during this recession by much less than in previous ones, especially considering the much larger fall of GDP this time (Chart 3.11). Lower unemployment than otherwise has had a positive impact on German confidence and revenues, thus boosting consumer demand. A rough estimation of this impact on consumption growth is about 0.4 p.p. in 2009.

The impact of fiscal measures is temporary. There is uncertainty on what will happen to private demand once they have disappeared.

The “temporary” nature of fiscal stimulus measures was one of the three conditions of the optimum fiscal package that were much debated a year ago (the famous three “T”; the other ones were “targeted” and “timely”). The plans approved by European governments were intended to be temporary for its most part, although a tougher issue is there will be political will to retire other measures. Car purchase programs have expired in some countries; some public investment plans that were rapidly implemented (like local public works in Spain) have only been extended partially; VAT reductions in Britain were designed for a limited period and are about to expire; other transfer programs were approved for the fiscal year 2009 and their extension to 2010 is not ensured. In principle, much of the stimulus will be applied in 2010 (our estimate is that the actual share of the fiscal spending will be larger in 2010 than in 2009), but the impact of these measures is difficult to predict. Under our baseline scenario (see below), private demand will still be weak by the end of 2010, and therefore there is a risk of a backlash in activity once the stimulus wanes.

The main weakness ahead is the lack of restructuring of the banking system

Apart from the uncertainty that surrounds the impact of fiscal policy, the other main source of risk for the European economy is the state of the financial sector. As shown in Box 3, the banking sector in the Eurozone has not gone through a process of deleveraging as important as that of US banks, and indeed their current leverage ratios are much higher than those of their US counterparts. This higher leverage is not justified by the structure of risks of their assets.

The banking sector is a much more important source of finance for the rest of the economy in the Eurozone than in the US or the UK. Bank credit is key for future developments. Banks have been tightening their credit standards over the recent quarters, partly because economic conditions are much worse and lending has become more risky (Chart 3.12, credit growth). Although most of the deceleration of credit growth to the private sector can be explained by lower demand, the strength of the banking sector is key for future growth. The example of Japan in the 1990s, where banks did not restructure and did not have the financial strength to embark in new financing projects is a warning for Europe that lack of action on this front may derail the recovery for a long time.

3.2 The outlook for 2010 presents a very slow recovery

Our projections for 2010 are of a very slow recovery, with a backlash in the first half of the year

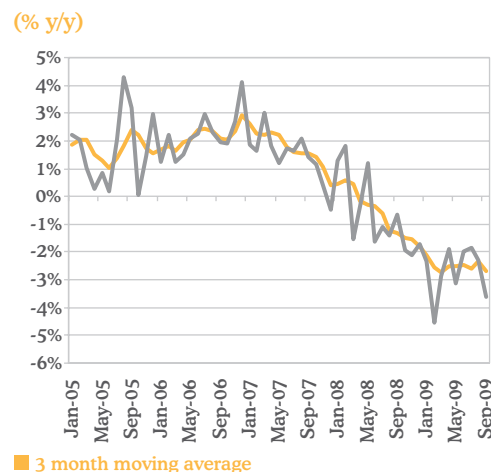
Based on short-term indicators described above, the fourth quarter of 2009 is expected to show further growth in the Eurozone, in line with that recorded in the third quarter. Our Synthetic Activity Indicator (SAI) suggests that GDP will grow around half a percentage point in this quarter (Chart 3.13) after 0.4% in Q3.

After that, there is much uncertainty on the ability of the Euro area to continue growing. There are several drivers that will shape the evolution of activity, including those already mentioned in the previous section.

- On the positive side, export demand from emerging countries is likely to be strong, while the US will return to growth in 2010. Overall, given the still low share of EA exports to emerging countries, growth in that area alone is not likely to bring on its own the level of exports back to pre-crisis levels. Second, the level of inventories should recover sooner or later, given the large rundown of the stocks level experienced at the beginning of the year. We were expecting already a large positive contribution from inventories in Q3, but this has probably not happened (the decomposition has not been released yet). Third, interest rates are likely to continue at very low levels.
- On the negative side, apart from the situation of the banking sector and the risks of credit stagnation, consumers will likely continue increasing their savings rate, probably less for a precautionary motive and more to repair their balance sheets after the losses incurred after the fall in asset prices. More importantly, those fiscal programs with a large impact on growth mentioned above are likely to disappear, although employment subsidies in Germany could continue. Other fiscal outlays will continue to arrive, although the confidence channel that they enticed when they were announced is unlikely to be repeated. Finally, on the external side, the exchange rate vis-à-vis the US dollar is at historical highs, and will have a delayed impact on exports during the course of 2010. Our work hypothesis for the euro-dollar is that it will slide slowly to 1.35 by the end of the year.

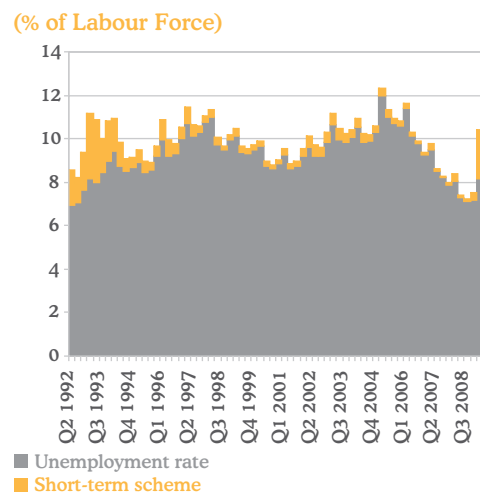
With these assumptions in mind, our projection is for private consumption to grow very slightly on average, while public consumption (which does not include most of the fiscal programs, since they are materialized in

Chart 3.10. Euro Area: Retail sales



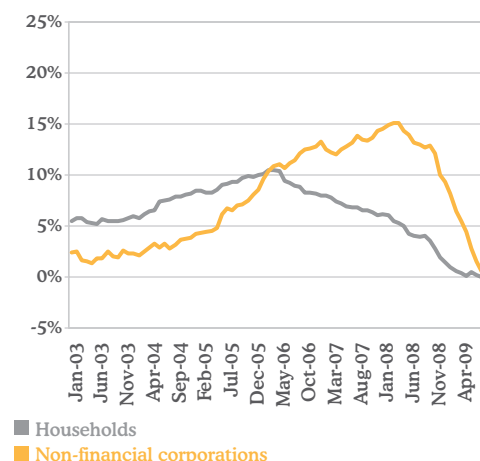
Source: Eurostat and BBVA

Chart 3.11. Germany: Unemployment rate and Short-term schemes



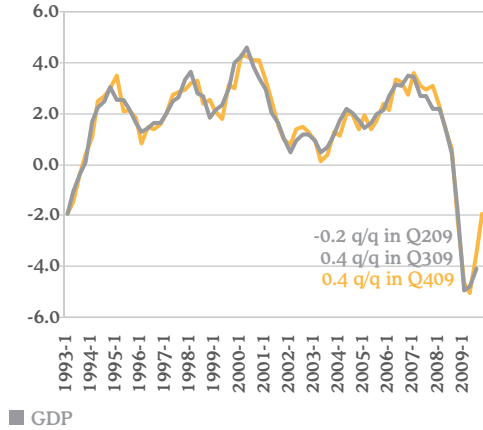
Source: Eurostat

Chart 3.12. Euro Area: Credit to the private sector y/y growth rate (local currency)



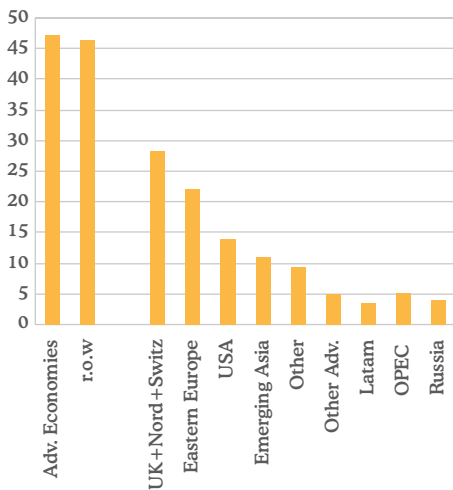
Source: ECB and BBVA ERD

Chart 3.13.
Eurozone: GDP
(% y/y)



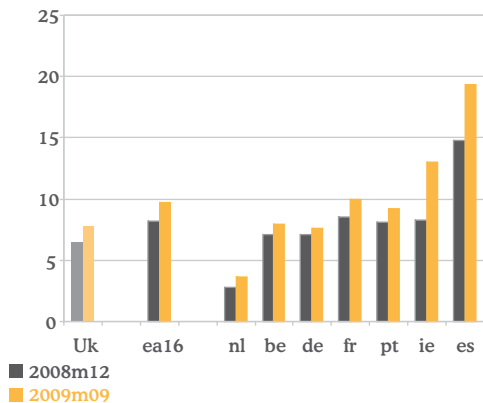
Source: Eurostat and BBVA ERD

Chart 3.14.
Extra-Eurozone exports share by partner
(2005-2008)



Source: Eurostat

Chart 3.15.
UK and Euro Area:
Unemployment Rate



Source: Eursotat and BBVA

transfers or investment spending) should follow historical trends and grow by close to 2%. Gross fixed capital investment is expected to fall further, given the very high rate of unused capital and the lack of a pull factor among other demand components. On average for the year it is projected to fall -1.5%. Inventories are assumed to contribute to growth with 2 decimal points. All in all, domestic demand should grow by 0.4%.

On the external side, exports (Chart 3.14) will recover slightly less than imports, as the exchange rate effect compensates the pull factor from stronger World growth, detracting one decimal point from GDP growth. Overall, GDP is expected to grow only very marginally over the year, by 0.2%.

Employment is expected to fall by 1% in 2010 after -1.7% in 2009 due to the lagged effects from the fallout this year, while apparent labour productivity growth should recover to above 1%. The unemployment rate will continue growing to close to 11%, with large differences across countries, following the disparaging trends already seen this year (Chart 3.15).

Across countries, there will be no major differences in the large three countries of the Euro area.

Germany and France are expected to grow above the average, but still with a timid 0.7% and 0.6%, respectively. In the first case, the contribution of investment demand, which has already grown in the third quarter, should be positive, pulled by exports. Consumption should be flat as the effect of the car purchase program wanes, although there is an upside risk of higher consumer spending if finally income tax cuts are implemented soon in 2010. In France growth will mostly be explained by the resilience of consumption (+0.5%) after a similar figure expected to 2009. In both countries, the contribution of external demand will be slightly negative.

Italy is expected to grow more slowly, at about the same rate as the area as a whole, with weak or negative rates in most of its components. In Spain, the ongoing adjustments in the economy, in particular in the construction sector, will result in negative growth of -1.2%, with a fall in private consumption due to high unemployment and the increase in VAT. Outside the Eurozone, the UK is expected to grow by 0.5%, thanks to the positive contribution of the external sector induced by the depreciation of the pound over the last year (see Box 4).

3.3 The right balance of exit strategies should be biased towards avoiding a backlash

Spare capacity is very large and core inflation is decelerating

One of the consequences of the financial crisis has been a decrease in the growth potential of European economies (Box 5). However, the output losses have been so large that the output gap has widened and will take time to close. As a consequence, disinflationary forces have developed and, together with the negative base effects derived from high energy prices one year ago, have resulted in negative inflation rates in the Eurozone during the central months of 2009. This negative inflation in annual terms is likely to have disappeared in November, but monthly inflation remains weak, and core inflation continues to decelerate and stands at 1% (it was close to 2% in January).

A standard Phillips curve that takes into account past inflation, import prices and an output gap that remains high (around -5% on average for 2010) predicts inflation to remain below 1% for most of 2010, with a probability distribution that does not exclude deflation with a sizeable probability (Chart 3.16).

The ECB is focused on a gradual exit strategy from liquidity injections; but an early strategy could kill the current recovery

If inflation is subdued, broad money aggregates (in particular M3) have been also decelerating (Chart 3.17), while M1 has increased due to shifts

in relative remunerations across assets. Although credit to the private sector has stabilized, some members of the ECB council fear that the high levels of M0 resulting from liquidity injections will fuel inflation in the medium term, despite the very subdued outlook derived from Phillips curve exercises. Hence, plans to withdraw liquidity from the economy will most probably be announced at the December 2009 meeting. The plan could set a guide for action on the continuation of longer term auctions (12, 6 and 3 months), on the maintenance of full allotment auctions for liquidity (in remaining long-term auctions and in weekly auctions) and maybe on the collateral accepted for ECB loans. The outcome of the December meeting is difficult to predict, but it will likely incorporate a gradual approach to the exit of monetary stimulus. Although the December 12 months auction will likely be the last one, the key feature of full allotment auctions will probably remain in place. It is also possible that the ECB unveils only part of its strategy, leaving further decisions for coming meetings.

On the issue of official interest rates, recent declarations by many ECB council members suggest that they will be delayed until after liquidity is retired, and are for now out of the picture. Given our baseline GDP and inflation projections, we expect that the *repo* rate will stay at 1% until mid-2011. The high level of the euro-dollar exchange rate and the declared intentions by the US Fed to leave rates low for a protracted period of time play also in favour of this scenario.

The reversal of fiscal stimulus will be a long and painful process. It should wait until the recovery is underway and be a decisive and transparent process

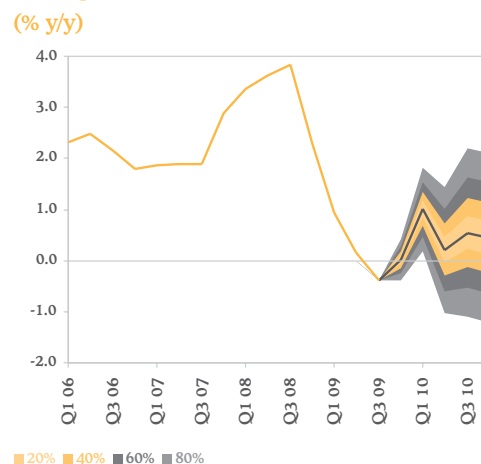
Box 1 paints a difficult picture for the fiscal outlook in the Eurozone, as most countries have seen a very large increase in their deficit and gross debt ratios over GDP as a consequence of the cyclical factors, fiscal packages and the increase of structural deficits beyond those packages. Consolidation plans have started to be drawn, at different speeds depending on the countries, and often with conflicting declarations on future intentions (complicated in some cases by current or foreseeable changes in the political landscape).

The European Commission has recently extended the period for governments to comply with the Stability and Growth Pact, which requires deficits to return to below 3% of GDP in the medium term. For most countries, the new deadline for attaining the 3% benchmark is 2013, which still requires a significant consolidation of public accounts. In practice, the ability to enforce the pact by the European Commission or by peer pressure from other countries is limited, and the actual pace and modalities of this process will probably be influenced more by national considerations. In this respect, the outlook in several large countries is unclear: In Germany, the new government coalition has announced tax cuts by the equivalent to 1% of GDP in the next two years, but they still need to be defined; at the same time, a new constitutional law requires structural consolidation by 2010. In France, the government has launched a spending program of more than 1% of GDP to be partly financed by resources that are not included in the Maastricht definition of deficit but will entail a fiscal deterioration, at least to some extent. In the UK, the upcoming elections, with a likely government change, implies that the actual strategy to reduce deficits from the current 12% of GDP is not known (current plans assume growth rates much higher than the ones we expect).

Fiscal consolidation will be long and difficult, given the starting point. Ideally, it should follow two simple principles: Maintaining the currently approved stimulus to avoid a double-dip recession (and be prepared to do more if the recession returns anyway), and designing a credible strategy in a transparent way, based on realistic growth assumptions. The first requirement is relatively easy to fulfil (governments are waiting until the recovery sets in) but the second has barely started.

Chart 3.16.

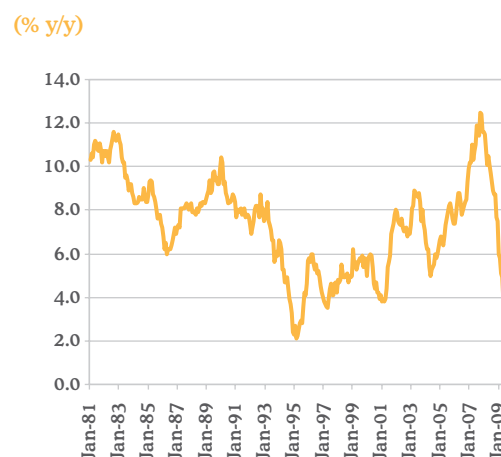
Eurozone: Projection of HICP from Phillips Curve



Source: Eurostat and BBVA ERD

Chart 3.17.

Eurozone: M3

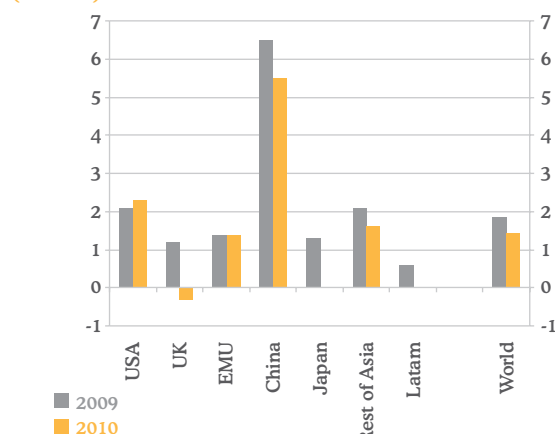


Source: ECB

Box 1. Fiscal policy: Too early to tighten

After several years of improved fiscal performance in European countries, the leeway to use fiscal policy as a countercyclical tool has increased and has made possible to implement expansionary measures in response to the deep turmoil, in addition to those embedded in automatic stabilisers. Most member states (in particular Germany and Spain) launched fiscal packages for 2009 and also 2010, which have been smaller than those implemented in the US (2.1% in 2009 and 2.3% in 2010) and China (6.5% in 2009 and 5.5% in 2010), but still significant (Chart 1). Although these measures have not been coordinated in their size or design (in fact, fiscal plans have been very diverse across countries, see table 1), they represent a unique example of coordination in their timing, preventing a rapid fall into depression.

Chart 1.
Fiscal programs: Relative size
(% GDP)



Source: BBVA ERD

Table 1.
Fiscal stimulus as % of GDP

		2009	2010
Total EMU	Expenditures	0.6%	1.0%
	Revn or transfers	0.9%	0.4%
	Total	1.4%	1.4%
Germany	Expenditures	0.7%	0.8%
	Revn or transfers	0.8%	1.0%
	Total	1.5%	1.8%
France	Expenditures	0.3%	2.3%
	Revn or transfers	0.8%	0.5%
	Total	1.1%	2.8%
Italy	Expenditures	0.0%	0.0%
	Revn or transfers	0.3%	0.0%
	Total	0.3%	0.0%
Spain	Expenditures	1.0%	0.4%
	Revn or transfers	1.5%	-0.2%
	Total	2.6%	0.3%
UK	Expenditures	0.3%	-0.6%
	Revn or transfers	0.9%	0.3%
	Total	1.2%	-0.3%

Source: BBVA ERD

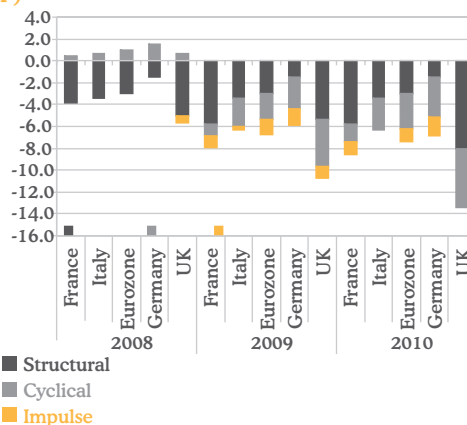
On top of this effect, automatic stabilisers have also responded swiftly, helping to stabilize the business cycle. The size of these automatic stabilisers depends on how progressive is the tax system and on the generosity of the welfare system. In principle, automatic stabilisers are of limited scope in circumstances such as the ones experienced in recent months, with large falls in confidence and sharp rises in risk aversion. We have estimated fiscal elasticities in the Euro area, which together with our our projections for both the GDP and potential output let us project the cyclical component of fiscal deficits. Table 1 shows the estimated elasticities of the cyclical component of the government net lending to the output gap, suggesting that the automatic stabilisers are bigger in the European economies than in the US (which explains also why the need for discretionary fiscal measures is higher in the US than in Europe).

Table 2.
Elasticity of the cyclical component of budget balance to the output gap

	BBVA ERD	OECD	EC
EMU	0.6	0.5	0.5
Italy	0.5	0.5	0.4
France	0.4	0.5	0.4
Germany	0.7	0.5	0.5
UK	0.7	0.5	0.5
US		0.3	

Source: OECD, European Commission and BBVA ERD

Chart 2.
Fiscal deficits and components by countries
(% GDP)



Source: European Commission and BBVA ERD

Given our economic scenario, both the cyclical and the discretionary components will lead the significant worsening of the government net lending (Chart 2). Across large European economies, the largest deficit should be recorded in the UK, surpassing the 10% as percentage of GDP for both 2009 and 2010, mainly driven by the

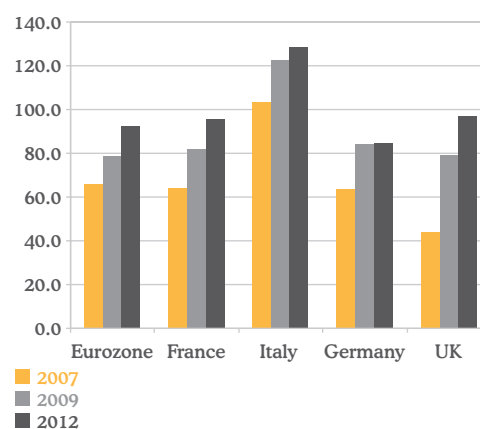
widening of its cyclical component. In France, the fiscal deficit should be around 8% in 2009 and continue to worsen slightly in 2010. Finally, the deficit in Italy and Germany is expected to be somewhat lower than that projected for the euro area as a whole (which is 6.7% in 2009 and 7.4% in 2010).

Overall, for 2010 the additional worsening of the public finances is widespread, partly due to the persistence of government spending, and obviously due to additional discretionary measures and the enlargement of the gap between real and potential GDP. In the medium-term, as the economy recovers, and thus the output gap closes or becomes positive, the cyclical deficit should disappear, as well as the fiscal stimulus when the recovery consolidates and European countries retreat them.

As national governments have to finance all these fiscal measures, their debt levels will also increase next years. To assess the impact of all these measures on the public debt as percentage of GDP, it is necessary to take into account the following factors: 1) the estimated government net lending, 2) the nominal GDP growth in coming years, and 3) the impact of measures adopted to support the financial system, which have not impact on government net lending under the Maastricht criteria but have increased gross debt. However, it is noteworthy that some of these latter measures are unlikely to materialize, because either banks do not use all the measures included in the national governments' rescue plans or banks have to repay the subsidies. In other words, higher liabilities due to interventions are matched by higher assets, with values difficult to estimate. Therefore, the estimated increase in debt as percentage of GDP may be substantially lower than estimated.

Chart 3.

EMU countries: Debt ratios over GDP



Source: BBVA

In summary, Chart 3 shows that the significant net lending deterioration will lead to a considerable increase in the debt to GDP ratio. The largest increase in this ratio will be recorded in the UK, to nearly reach 100% in 2012. In the euro area as a whole, the debt to GDP ratio should increase from 66% in 2007 to 92% in 2012, while in Germany and French they should be around that level. Finally, a lower debt increase should be observed in Italy, but the overall level will remain high.

In the medium term, if deficits are amended as a consequence of the improvement of economic outlook, as well as a result of the consolidation process included in the Stability and Growth Pact, the higher debt to GDP ratios should decline as the GDP grows. However, the leeway of fiscal policy as stabilizing tool in front of further shocks has virtually exhausted.

Box 2. On the effectiveness of vehicle scrapping schemes and their impact on consumption

Given the severe downturn recorded in the automotive sector all around the world and considering its scale and drag effects on activity and employment in the rest of the economy, the government response was swift: most vehicle-producing countries with an outstanding domestic market have launched significant sector rescue plans. Although both the magnitude and diversity of measures designed show large differences among countries, they can be broadly classified into three types: a) enhancing competitiveness, b) supporting production and employment in the medium term and c) stimulating demand in the short term. The latter consists of subsidies for the purchase of new or newly used vehicles – usually decreasing with the volume of CO2 emissions – in exchange for the scrapping of older ones, and they are primarily responsible for the recent recovery of growth in car registration in developed countries.

Germany, France and Italy have implemented direct subsidies to the acquisition of vehicles from late 2008 or early 2009, while Spain and the UK have started to apply them in May (Table 1). Overall, these schemes have boosted the demand for new cars (see Chart 1) and their impact has depended mostly on the generosity of incentives. In this box, the goal is to assess the functioning of scrapping vehicles schemes, estimating how much they have boosted the demand for vehicles hence macroeconomic aggregates. It is remarkable that the budgetary cost of these schemes is relatively small (around 0.1% of GDP in the euro area as a whole in 2009-10) when considering the size of fiscal packages implemented by European countries. By all means, these schemes have been one of the most cost-effective mechanisms to attain the goal of boosting short-term activity.

The additional demand generated by car subsidies is estimated here as the difference between observed sales figures and the forecast made in the month in which the plan started for each country, taking into account other factors that drive car demand (the normal renovation of cars by households, financial conditions or the confidence level). In order to have a conservative estimate of the impact of subsidies, we only take the upper 80% confidence band of the estimate. Additionally, the difference with respect the central forecast is also computed to evaluate the maximum additional demand¹. Chart 2 shows the additional demand estimated as a percentage of total new car registration, and indicates the strong impact recorded in Germany, while in France and Italy the effect was more moderate, due to the lower level of subsidies. In fact, the higher incentive in Spain and the UK have encouraged consumers to buy new cars and it may explain the significant additional demand in the third

¹ The maximum additional demand is one that gives all the forecast error to implementation of incentive plans. This upper limit is represented in the Chart 2 by the segment of each column.

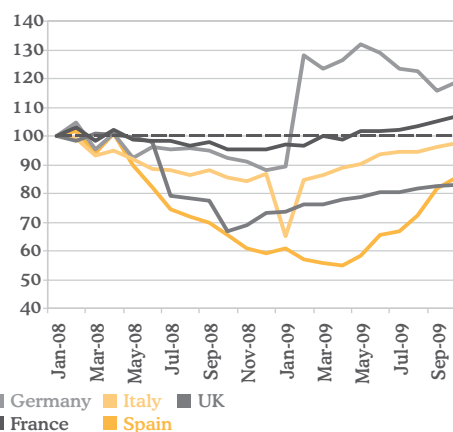
quarter (plans started later), more than in countries with a similar envelope such as France.

Table 1.
Vehicle scrapping schemes in selected countries

	Germany	France	Italy	Spain	UK
Incentive (€)	2500	1000	1500-5000	2000	2500
Envelope (€ millions)	5000	380	—	400	500
Vehicle age	> 9 years	> 10 years	> 9 years	> 10 years	> 10 years
Date started	14 Jan. 09	4 Dec. 09	7 Feb. 09	18 May 09	18 May 09
Expiry date	31 Dec. 09 (exhausted)	31 Dec. 09	31 Dec. 09	1 Oct. 10	28 Feb. 10

Note: French scheme has been extended until the end of 2010, but with a lower subsidy. Spanish one has also been extended.
Source: European Automobile Manufacturers' Association

Chart 1.
New car registration
(seasonally adjusted index, January 2008=100)



Source: ACEA and BBVA ERD

The effect of the additional demand for cars should be temporary and new car registrations are likely to fall as the schemes expire. However, a small effect on registrations is expected to continue in coming months as cars that were ordered under the scheme are delivered. Indeed, Germany's scrapping scheme expired in September but new car registration increased further in October.

More interesting is trying to assess the potential macroeconomic impact of these vehicle scrapping schemes. On the one hand, the additional demand for cars has had an upward impact on private consumption in the short run, as our estimation (computed taking into account both the additional demand and the average price of cars in each country) suggests for the first and second quarter in Germany (Chart 3). Specifically, German private consumption dropped by -0.1% y/y in Q1 and increased by 1.2% y/y in Q2, while if fiscal stimulus had not been applied, the consumption should have fallen by -1.1% y/y and -0.7% y/y in those quarters. In

France and Italy the impact was more moderate. Similarly, an upward impact is expected to be seen in Q3 in both Spanish and British private consumption, as they have implemented such schemes more recently.

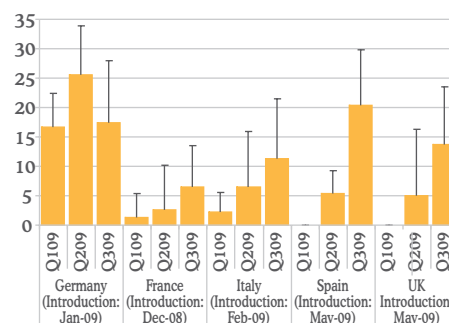
However, the positive impact estimated on private consumption may have been partly offset by other factors. First, in the short-run, by a possible substitution effect that the purchase of vehicles might have on the consumption of other durable goods, due to the direct impact of new car purchases on households' budget and the distorting impact on relative prices. The data on retail sales (Chart 4) excluding cars do not suggest that this effect has been significant. In fact, retail sales have risen or dropped at a lower rate in some countries (France and Italy) after the introduction of the rescue plans, while German retail sales have continued to deteriorate, but at similar rates to those recorded prior to the plan implementation. In addition, there are also some sectors whose activity is complementary to the automobile sector (such as insurance or after-sales services) that can benefit from this support. Second, some of the additional demand may have brought forward spending on car purchases, and thus these schemes may negatively affect private consumption in the medium-term. This could be the case of Germany: Under the reasonable assumption that all additional demand over the long-run trend of purchases was forward spending, this scheme may push down private consumption around -0.8pp during 2010. Additionally, this medium-term effect may be exacerbated if households reduce their savings or increase their borrowing, especially in the current situation of high indebtedness. Alternatively, the latter should be less worrying, if the additional demand reflects a pent-up demand due to the economic uncertainty (confidence fell as unemployment increased).

On the other hand, the effect of these schemes on total output (GDP) is difficult to assess for several reasons. First, some of the additional consumption demand due to these schemes may be met by imported cars (no information is available about how many of them may be eligible for scrapping schemes). Second, some of the additional demand may be met by stocks of vehicles cumulated as a consequence of the sharp drop in the demand for cars recorded by mid-2008. Overall, the short-run impact on national GDP growth is likely to have been positive, although relatively small. Third, the national GDP growth should be boosted by the foreign schemes via export demand.

As a further consideration that detracts from the short-term benefits of vehicle scrapping schemes, it should not be forgotten that car subsidies, as any other types of subsidies, have serious long-term consequences, as they benefit a specific industry, and thus distort both an efficient resource allocation and relative prices, delaying necessary structural measures. However, this effect is small to the extent that recent subsidies have compensated for an exogenous and extraordinary fall of confidence or bottlenecks in finance, not for a structural decline in demand.

Chart 2.
Additional demand effect of vehicle scrapping schemes

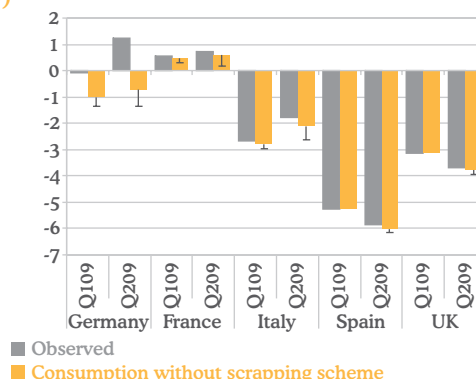
(% new car registration)



--]: upper limit if all the error forecast of the car registrations is considered as aggregated demand
Source: BBVA ERD

Chart 3.
Impact of vehicle scrapping schemes on private consumption

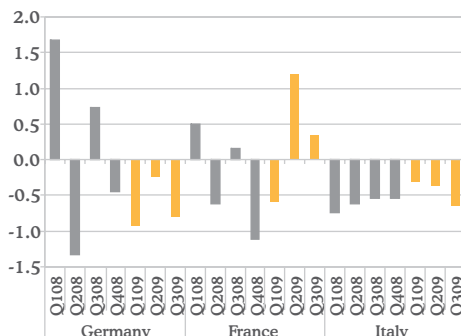
(% y/y)



--]: upper limit if all the error forecast of the car registrations is considered as aggregated demand
Source: BBVA ERD and Eurostat

Chart 4.
Retail sales excluding cars

(% q/q)



Source: Eurostat

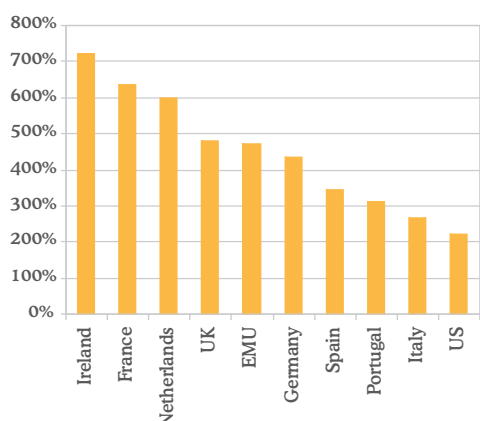
Box 3. The euro area banking system: No room for complacency

As the turbulence in financial markets originated by the collapse of Lehman Brothers starts to settle and economic recovery advances, the focus of investors and policymakers is shifting from mere survival to establishing the foundations of a more stable banking system. This is a very important task, because the underpinnings of economic recovery are dependent to a large extent on economic policies and subject to risks. The global economy could still be derailed by the withdrawal of fiscal stimuli, the normalization of liquidity provision policies, a new shock to commodity prices, a reversal of growth in emerging markets, or a combination of these developments. The risk here is that banking systems which are still fragile will be hit by these shocks and could worsen its consequences. The European economy is not immune to this possibility. In fact, a number of factors could render the European economy more vulnerable. In particular, banks are much more important for Europe, they are generally more leveraged –while facing similar risks– and restructuring is proceeding more slowly.

Banks are much important for Europe

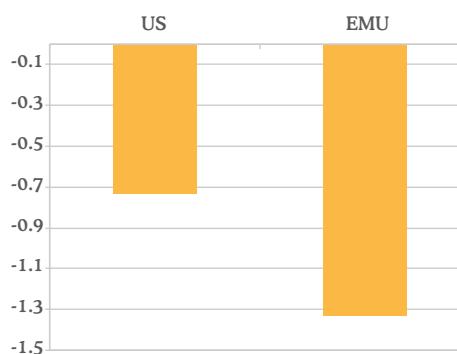
It is well known that the European economy has a larger weight of the banking sector, whereas in the US the importance of credit markets is larger. However, there are also substantial differences among EMU countries (Chart 1), with some countries' banking systems being exceptionally large. Additionally, the relevance of "national champions" is also higher for EMU countries. The top six US banks have combined balance sheets that represent 55% of US GDP. For most European countries it is not uncommon to find that the largest institution's assets are larger than that figure as a fraction of the country's GDP. Econometric models tend to corroborate the relevance of this dependence. Estimates incorporating leverage into a standard macroeconomic framework find that the impact on activity of a financial shock is larger for the EMU than for the US (Chart 2).

Chart 1.
Banking sector assets comparison
(2008) %GDP



Sources: Fitch, Fed and ECB

Chart 2.
Impact of financial shock on activity:
cumulative 2 year deviation from baseline
GDP trend

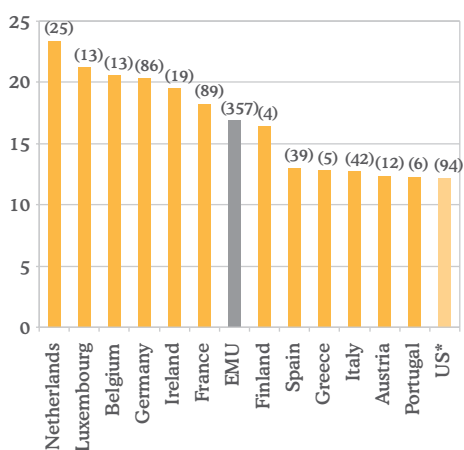


Source: BBVA ERD

Beware of excessive leverage

Two years after the eruption of the crisis, Euro area institutions are generally much more leveraged than their US counterparts. Comparability is always an issue when dealing with capital definitions, but the difference between ECB statistics on Monetary Financial Institutions and FDIC's depository institutions is stark: average leverage for EMU banks is around 16 times, whereas in the US the corresponding figure is 12 (Chart 3). This implies that simple capitalization is slightly below 6% for the EMU vs. 8.2% for the United States.

Chart 3.
European Monetary Financial Institutions:
Assets over capital plus reserves
Number in parenthesis: Assets over Euro area GDP



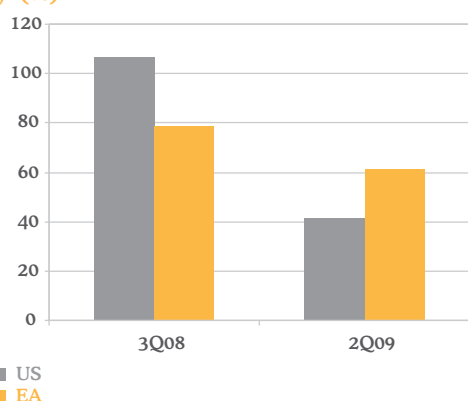
* US data refers to all-FDIC insured institutions. Common stock plus surplus is used as measure of capital. Parenthesis is ratio vs. US GDP
Source: BBVA ERD

Heterogeneity is also very significant inside the Euro area. The case of Germany and the Netherlands is particularly significant, as they both have leverage ratios above 20 (i.e., capitalization below 5%). In fact, the combined assets of banking systems with leverage ratios above 20 (Germany, Netherlands, Luxembourg and Belgium) represent more than 130% of European GDP.

Risks are very similar when higher leverage is accounted for

Measuring the risk of a financial institution is no easy task and it is clear that leverage per se is not necessarily a good measure of risk. Alternative indicators, however, suggest that Euro area institutions have engaged in activities carrying a level of risks that not so different to those observed in the US, when viewed against their capital buffers. For example, some Euro area banks have been at least as active as their US peers in the use of structured products. Even if total exposure as a share of assets is smaller, this result is reversed if the lower capital base of Euro area banks is taken into account (Chart 4). Regarding their evolution, although beginning from a similar situation, the decrease in structured products exposure has been larger for US banks than Euro area peers.

Chart 4.
Sample of large international banks
Structured products exposure over tangible equity (%)



Source: BBVA ERD

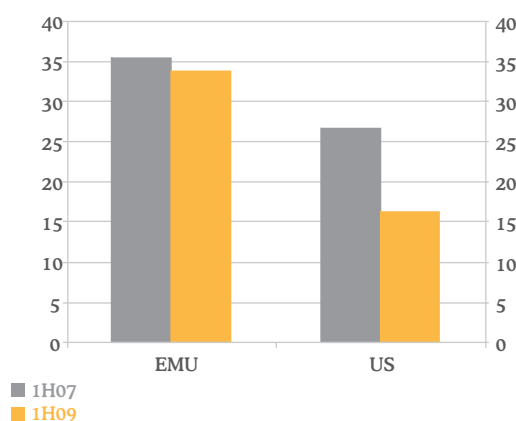
Deleveraging is proceeding more slowly

Of particular interest is the diverging evolution of leverage ratios across the Atlantic. Leverage has been decreasing over the last two years in the US –for a sample of the largest international banks– and now stands around half of its pre-crisis level. In contrast to these data, the average ratio for EMU has remained mostly stable (Chart 5). This data suggests US banks are advancing faster in strengthening balance sheets. This pattern can also be observed in Tier 1 capital ratios (Chart 6).

Conclusion: No room for complacency

As the global economy shows its first signs of improvement, European authorities must keep in mind that this recovery is to a large extent based on temporary policies. These have afforded a needed respite to the European financial sector, but it would be desirable to deepen the ongoing efforts at bank restructuring, improving coordination of national measures, to ensure that this strengthening continues in the future.

Chart 5.
US and EMU
Leverage: Assets over tangible equity



Source: BBVA ERD

Chart 6.
Sample of large international banks
Tier 1 ratio



Source: BBVA ERD

Box 4. United Kingdom: The British patient

The British economy has been particularly affected by the financial turmoil. Since the start of the crisis economic activity has fallen by 6% (above the 4% in the US and the Euro area), and its financial system was severely hit by the “credit crunch”. Fiscal and monetary policies have been intervening aggressively so as to avoid further deterioration.

Signs of stabilization in economic activity, but looking ahead weakness and uncertainty remain

In Q3 economic activity contracted for the sixth consecutive quarter. The preliminary figure shows a decline of -0.4% q/q, pointing to a moderation in the pace of decline after -2.5% and -1.9% q/q in the first and second quarters of this year, respectively. This further decline in Q3 came as a surprise as both soft and hard leading indicators were pointing to a stabilization.

What have been the drivers behind this further slump in Q3 is not clear as demand side components have not been released yet. In previous months both private consumption and investment have been dragging growth. While, the external sector has contributed positively to growth as imports declined rapidly. From the supply side, all activity sectors in Q3 have registered further declines, the most affected sector has been construction, cumulating a decline of -15% since the end of 2007.

Hard leading indicators are signalling the turning point

Several short-term leading indicators point to a recovery in economic activity. Industrial production rose in September 1.6% m/m. The housing sector, one of the most affected by the financial turmoil is showing signs of recovery. Different house price indices, such as Nationwide and Halifax, have resumed after 20 months registering negative rates. On average, these indexes have declined by 15% since October 2007. Retail sales have registered two consecutive monthly increases and vehicles registrations are showing positive outcomes thanks to the government car-scraping scheme (see Box 2).

Household imbalances will keep consumption subdued

Household consumption will remain subdued in coming quarters as British households are highly indebted and need to restore their balance sheets. Consumption decisions are being postponed, which reflects in a higher

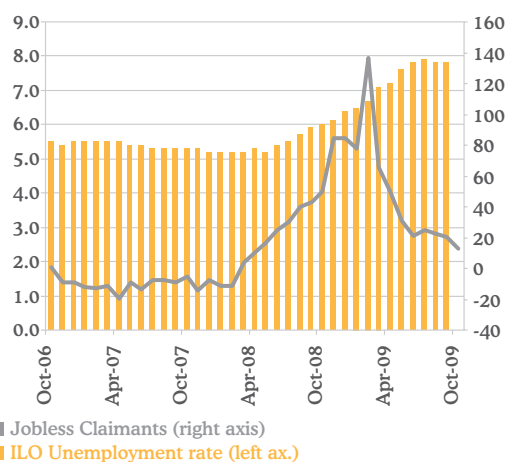
saving rate. In Q2 this ratio (as percent of disposable income) reached 5.6%, the highest level since 2002 (it even registered negative rates in Q1 2008). Income uncertainty is leading to an increase in precautionary savings, although the recent relatively positive performance of employment and fiscal support should help to outweigh the negative impact on consumption, which has declined -3.5% since last year (a much sharper decline than the -1.5% in the Eurozone).

Among the support elements for private consumption, it is worth mentioning the car scrappage scheme and the temporary VAT reduction. All in all, private consumption will continue to fall in 2010, but a much slower pace as long as labour uncertainty fades away.

In spite of the size of the decline in activity, employment seems to be responding relatively well. After an initial peak of claimants and lay-offs in February, the pace of employment destruction is moderating. This is likely a sign of a flexible labour market, where lay offs have been substituted by reductions in working hours or downward salary adjustments. The latest claimant count rate in October shows that it increased by just 12,900 being the smallest rise since April 2008 (in February the number of claimants raised by 138,000).

The ILO unemployment rate increased by 1.3 pp, from 6.5%, by the end of 2008, to a 7.8% in September this year. Compared to other economies, the increase in the unemployment rate has been small. In the Euro Area it increased from 8.2% to 9.7%, though there is much dispersion within eurozone members (Chart 1).

Chart 1.
UK: Labor market performance



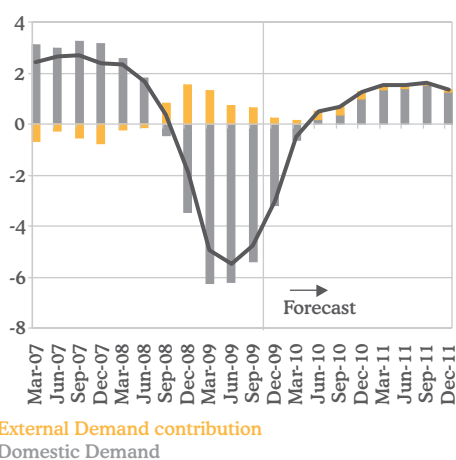
Source: ONS and BBVA

Government investment has replaced part of the decline in private activity

Investment remains subdued as tight financial conditions, spare capacity and weak demand have led to an uncertain environment for firms. The fiscal stimulus package included advances in infrastructure investment of 2,5 bn GBP and tax incentives for businesses should help to buffer the impact from lower private demand. Recent confidence surveys point to a recovery in investment.

Chart 2.

UK: GDP forecasts



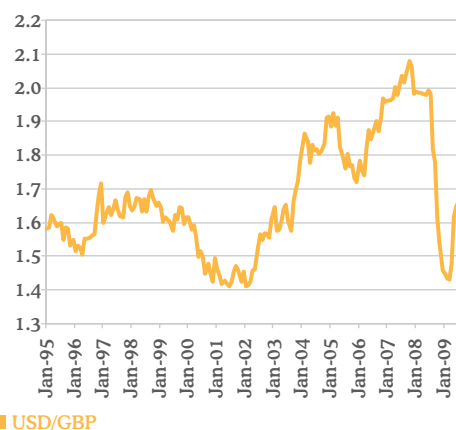
Source: BBVA ERD

External demand will continue to contribute positively, helped by the sterling depreciation

The external sector has been contributing positively to growth in the last quarters as the decline in imports has been larger than that in exports (Chart 2). Looking ahead, the strength of British exports will very much depend on global activity recovery and sterling developments. The GBP has depreciated against major trading currencies since July 2008 (Chart 3) The Eurozone and the US, the main trading partners of the UK, are showing signs of recovery, but it will be weak.

Chart 3.

Exchange rate developments



Source: Bloomberg

Inflation remains below target, but the VAT increase in 2010 and economic recovery will drive prices up in the short term

Due to energy base effects and restrained demand that is weakening firms pricing power, CPI inflation (the Bank of England reference indicator) has remained below the 2% target for several months, but far from the negative rates observed in many European countries.

Looking ahead, we expect inflation to be temporarily above target as there are several factors pushing in the same direction. In January 2010 the VAT will return to 17.5% after 13 months at 15%. This was one of the measures taken by the government to support consumption during 2009. The reversion of this measure will push prices up and some consumption will be anticipated. But after this episode we expect inflation pressures to be mild, in line with a slow recovery and a large spare capacity after the large output losses from this year.

Monetary Policy: to remain relaxed

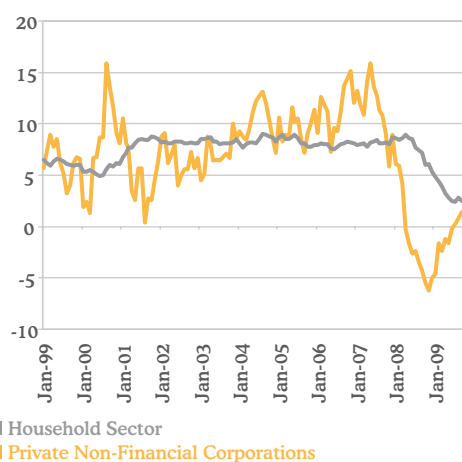
Since the start of the crisis the Bank of England (BoE), as other Central Banks, has intervened aggressively to ensure both financial and economic stability. Official interest rates are currently at its lowest historical level at 0.5%, after 450 bp cut since October 2008.

Given the proximity to the lower bound, the BoE started to make use of non conventional measures in March 2009, when the BoE announced the "Asset Buying Programme" to buy government debt in secondary markets¹. It started

¹ For a detailed analysis on Quantitative Easing and other non-conventional monetary policy tools see "Panacea, Curse, or Nonevent? Unconventional Monetary Policy in the UK" André Meier, IMF WP/09/163

initially with 125 bn GBP and up to now it increased the objective/quantity two times more. The latest increase took place in November and it was of 25 bn GBP, up to 200 bn GBP. The BoE particular format of QE (purchasing gilts from asset managers) has led to a rise in financial companies' deposits, followed by an outflow of deposits as asset managers purchase riskier corporate assets. The latest data on M4 lending and counterparts show signs of this channel at work (Chart 4).

Chart 4.
M4 sectoral breakdown
seas. adj, % y/y



Source: Bank of England

Official interest rates will start to rise in the first quarter of 2011

We expect the Bank of England to maintain interest rates at its present level all through 2010, since activity will be subdued and inflation remains around the target. Then interest rates should increase by the beginning of 2011.

Aggressive fiscal stimulus leading to concerns on sustainability

In addition to monetary policy measures, several tools have been used on the fiscal front (see also Box 4). Together with the fall in revenues due to the decline in economic activity the British economy will record the largest fiscal deficit as percentage of GDP, it will largely surpass the 10% deficit for 2 years.

The estimated cost of the fiscal package for the 2009-2012 period is estimated at 2% of GDP. Among the measures taken in order to support the economy, the most costly in terms of loss of revenues is the VAT reduction in 2009, in addition to public capital investment brought forward. The twin fiscal rule² has been temporarily suspended in favour to a more flexible and temporary fiscal rule. Public accounts are deteriorating rapidly, leading to unprecedented fiscal deficits and government debt expected to be close to 100% of GDP by 2013-14.

Looking ahead, we expect that in the pre-budget report for the fiscal year 2010-2011, to be announced at the beginning of December, a fiscal plan consolidation plan will be proposed. However, given that elections will be held by the beginning of next year, uncertainty remains high on the fiscal front.

² The Twin fiscal rule consists of the following: (1) The "Golden rule" where over the economic cycle the government only borrows to invest, current spending is only paid through taxation. (2) The "Sustainable spending rule" requires that over the economic cycle the level of debt is held at a prudent level at around 40%.

Box 5. Potential Output: Lower growth after the downturn

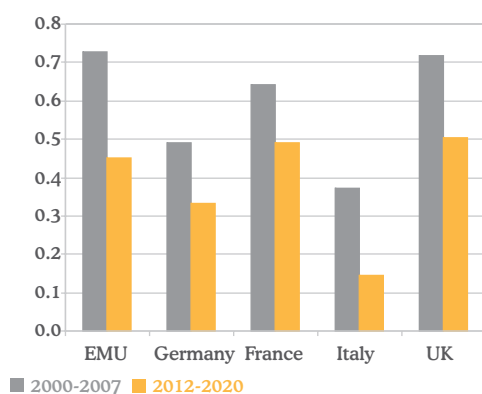
The purpose of this box is to assess the impact of the current recession experienced by European economies on the long-term evolution of its production factors and productivity, and thus on the potential for economic growth and welfare. Overall, the financial market turmoil and the high unemployment rate will provoke a sizeable drop in potential output in the short and medium-run. The effect is more uncertain in the long-term, as structural reforms or deep sectoral shifts may be ignited by the current crisis, leading a more efficient resource allocation.

The investment collapse will reduce capital accumulation

One differential element of the current recession as compared to previous ones has been the sharp fall recorded by investment, reflecting the drop in exports and to some extent in private consumption. This collapse of investment (about -11% in the euro area and -13% in the UK in 2009) will induce a significant reduction in the growth of capital accumulation. Given the subdued expectations of future demand and the financial constraints that the crisis may have generated, the capital stock will grow at a slower pace than before the crisis for a protracted period of time.

Chart 1.

Capital stock contribution to potential GDP growth (in percentage points)



Source: BBVA ERD

The current recession has also highlighted the need for structural adjustments in specific productive sectors (especially construction), which will take time to unwind and will involve the destruction of some installed capital due to permanent excess capacity, but will also allow a more efficient allocation of resources in the medium term. Conversely, it is also worth noting that some counter-cyclical measures that have been taken to minimize the impact of the crisis on activity (vehicle scrapping or short term unemployment schemes), could have adverse effects on potential growth in the medium term as they may have delayed some necessary structural adjustments.

Another channel through which the financial crisis will likely have an impact on capital formation will be real interest rates, which will be higher in coming years than in the recent past. Higher real rates, combined with high private sector indebtedness, will discourage or delay some new investment plans.

Overall, in our medium-term economic outlook the lower accumulation of capital will reduce its contribution to growth potential in around 0.3pp (Chart 1).

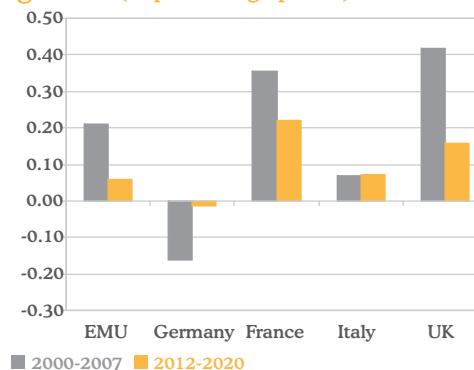
Labour input also reduced its contribution to potential growth

The current and foreseeable increase in unemployment may bring a temporary increase in its underlying (structural) rate, due to the rigidity of the labour markets in Europe (employment protections laws, generous unemployment benefits) and to the existence of long adjustment lags, but the structural unemployment should revert to pre-crisis levels if the industrial reallocation of labour was completed. In any case the long-term effect should be limited. However, the risk of a protracted period of higher structural unemployment should not be ruled out (in the absence of structural reforms), as the loss of human capital coupled to long-term unemployment make it more difficult to find jobs, resulting in the so-called hysteresis effect.

According to the trends projected by the European Commission (EUROPOP2008), the pace of growth of the working age population recorded in recent years will not be maintained over the medium term, reflecting the low birth rate in developed countries and the reduction of migration flows as a consequence of labour market deterioration. In the euro area as a whole, these prospects represent a 0.2pp lower contribution to potential growth (Chart 2).

Chart 2.

Population 16-64 contribution to potential GDP growth (in percentage points)

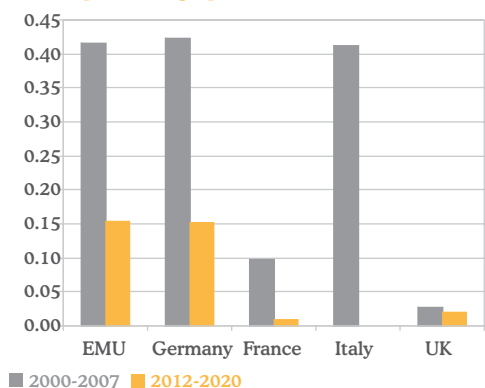


Source: BBVA ERD

The significant increase in the participation rate in recent years has been another factor explaining the raise of potential output in developed economies. However, this rate is already at high levels and is unlikely to grow as fast

in coming years as in the past. Additionally, the effect of the crisis on labour force participation in the medium term is ambiguous. On the one hand, the deterioration of the labour market may discourage job search and reduce the labour force, especially if there are incentives for early retirement. On the other hand, some people could join the labour force to compensate for lower households' income or wealth. Overall, our scenario assumes lower gains in labour force participation rates, thus reducing their positive contribution to growth by around 0.2pp in the euro area as a whole (Chart 3).

Chart 3.
Activity rate contribution to potential GDP growth (in percentage points)



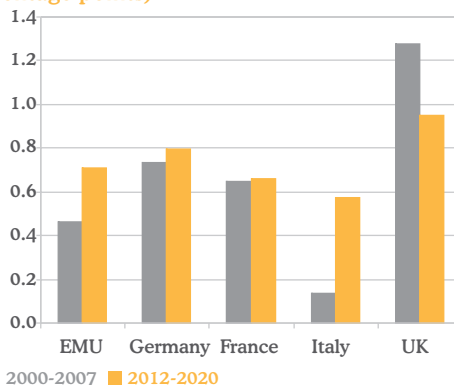
Source: BBVA ERD

Total factor productivity will grow more as a result of a more efficient resource allocation

The effect on productivity is also ambiguous. First, in the short run the increase in unemployment (labour intensive and low skill sectors) may lead to higher productivity (there is a high correlation between an increase in the unemployment rate and an increase in productivity). However, some countries (Germany, United Kingdom), which have been applying subsidies to support employment, may experience a decline in productivity. Furthermore, the tightening of financial conditions, as a consequence of higher risk aversion, may cause a lower allocation of funds to innovative projects. Second, in the medium-term productivity may increase because the downturn may drive out inefficient firms and provide incentives for a sectoral restructuring that involves a reallocation of resources towards more efficient industries. Our outlook envisages a moderate increase in the productivity contribution (Chart 4), which partly offset the adverse effects on other factors on the euro area as a whole. In the case of the Italian economy, the rebound of its contribution in coming years is mainly due to a statistical effect, after its significant decline in recent years as a consequence of the strong employment growth of low-skilled jobs in the early 2000s (linked to labour market reforms). In the case of the UK, the likely adjustment in the banking sector (a high value added sector) may lead

to a considerable reduction in the growth of total factor productivity.

Chart 4.
TFP contribution to potential GDP growth (in percentage points)



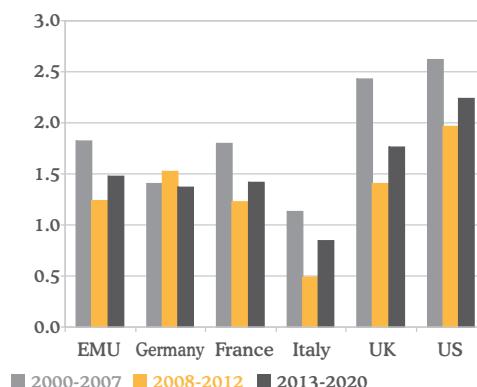
Source: BBVA ERD

In the absence of structural reforms, potential growth will slow down and the gap with the US economy will persist

In sum, according our estimation, the lower potential growth would be widespread across European economies, declining from 1.8% to 1.5% in the euro area as a whole (Chart 5). Additionally, the gap on potential growth with respect the US will be maintained.

Lessons from previous recessions (Great Depression or Japan) point to the first priority must be to ensure the functioning of the financial market (capital accumulation) and to apply structural reforms aimed at increasing labour market participation and worker employability (labour), as well as ensuring the knowledge economy (total factor productivity). This is a wide reform program.

Chart 5.
Potential GDP growth (% average)



Source: BBVA ERD

4. The determinants of European Inflation: An assessment of the role of macroeconomic variables and institutions

Summary. There seems to be a role for product and labour market institutions in explaining the heterogeneous response of inflation to macroeconomic shocks across European countries. We present new evidence suggesting that an institutional environment that combines high coordination and low unionisation in the labour market with high competition in the goods market would be the most successful in achieving price stability in the event of either common or idiosyncratic macroeconomic shocks. Had the high-inflation EMU countries exhibited the best observed institutional scenario, their annual average inflation rate since the establishment of the EMU would have been 0.7 percentage points lower, thus virtually closing their respective area-wide inflation differential.

4.1. Introduction

The empirical modelling of the inflation processes that have characterised the developed world is a recurrent theme in macroeconomics. Not least so in the current times, when uncertainty about the evolution of the factors that shape inflation is, probably, at a historical peak. Typically, the inflation process has been modelled by means of reduced-form inflation specifications that take the form of expectations-augmented Phillips curves. In these specifications, inflation is influenced by its own lag or lags, as a proxy of backward-looking inflation expectations, the unemployment gap, as a proxy of cyclical position or excess demand, and productivity growth, import price inflation and tax changes, all of them as proxies of the evolution of production costs or unanticipated cost shocks. The theoretical underpinning of such equations is usually given by price-setting and wage-setting rules that, ideally, would also capture some stylized facts of the economy in question, such as exogenous wage-push factors of a certain nature.

The literature has established that the demand- and cost-side variables determining inflation dynamics in the post-war period are indeed similar across OECD economies, a sample of countries that includes the most advanced European nations (Bowdler and Nunziata, 2007). However, one would naturally expect the presence of cross-country heterogeneity in the size of the impacts of those macroeconomic determinants, namely as a result of underlying structural differences that prevail across countries. In this spirit, this article investigates the effect of a set of institutional factors on the response of inflation to macroeconomic conditions. It does so in the context of a multi-country OECD panel data model constructed yearly for the period 1960-2006. The analysis departs from the hypothesis that inflation adjustment to common macroeconomic shocks depends upon the institutional environment that characterises each economy (see Burdekin and Siklos (1999), Boschen and Weise (2004), Bowdler and Nunziata (2007)).

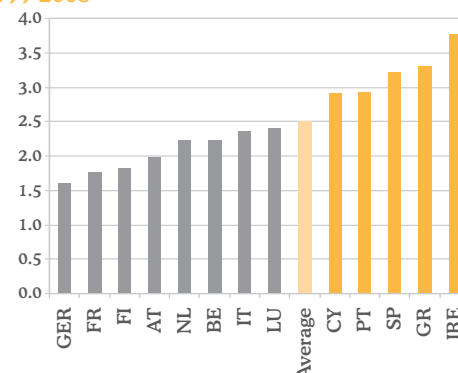
The institutional features considered here include the degree of coordination among labour organisations in the wage bargaining process (COORD), the percentage unionisation of the labour force (TU), and the degree of competition that prevails in goods markets (PMR). The first two institutional characteristics were analysed in Bowdler and Nunziata (2007) for the period 1960-1995. As a contribution to the literature, this study specifically argues that institutional features of the

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Chart 4.1.

Euro Area: Average inflation rate

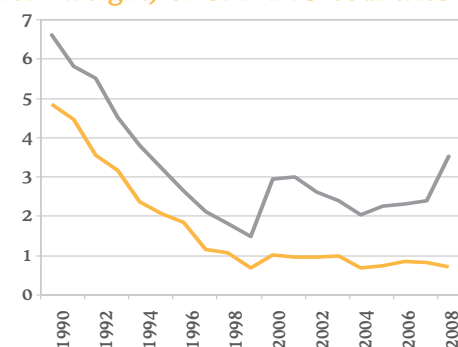
1999-2008



Source: Eurostat and BBVA ERD

Chart 4.2.

Mean and standard deviation (non-weight) of CPI EMU countries



■ Standard Deviation
■ Average

Source: Eurostat and BBVA ERD

Table 4.1. Annual inflation rates across EMU members, selected years (in percentage terms)

	1999	2001	2003	2005	2006	2007	2008
Average	1.5	3.0	2.4	2.3	2.3	2.4	3.5
Austria	0.6	2.6	1.4	2.3	1.4	2.1	3.2
Belgium	1.1	2.5	1.6	2.8	1.8	1.8	4.5
Germany	0.5	2.0	1.1	1.5	1.6	2.3	2.7
Ireland	1.6	4.9	3.5	2.4	3.9	4.9	4.1
Greece	2.6	3.4	3.5	3.5	3.2	2.9	4.2
Spain	2.3	3.6	3.0	3.4	3.5	2.8	4.1
France	0.6	1.6	2.1	1.7	1.7	1.5	2.8
Italy	1.7	2.8	2.7	2.0	2.1	1.8	3.3
Cyprus	1.5	2.0	4.1	2.6	2.5	2.4	4.7
Lux.	1.0	2.7	2.0	2.5	2.7	2.3	3.4
Netherlands	2.2	4.2	2.1	1.7	1.2	1.6	2.5
Portugal	2.3	4.3	3.2	2.3	3.1	2.5	2.6
Finland	1.1	2.6	0.9	0.6	1.6	2.5	4.1

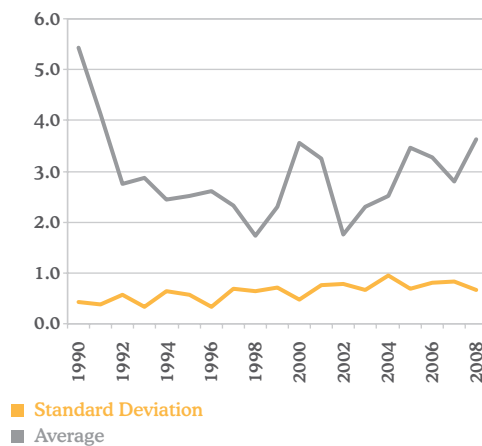
Note: In shadow, countries with inflation rate above average of the corresponding year.
Source: Eurostat.

Chart 4.3.
US: Average inflation rate



Source: Bureau of Labor Statistics and BBVA ERD

Chart 4.4.
Mean and standard deviation (non-weight) of CPI US metropolitan areas



Source: Bureau of Labor Statistics

Table 4.2. Annual inflation rates across U.S metropolitan areas, selected years (in percentage terms)

	1999	2001	2003	2005	2006	2007	2008
Average	2.3	3.3	2.3	3.5	3.3	2.8	3.6
New York	1.9	2.5	3.1	3.9	3.8	2.8	3.9
Philadelphia	2.2	2.7	2.1	3.9	3.8	2.2	3.2
Boston	2.4	4.4	3.7	3.2	3.2	1.9	3.7
Chicago	2.1	2.6	1.8	3.0	2.0	3.3	3.8
Detroit	2.6	2.6	1.9	3.0	2.9	1.8	2.2
Cleveland	1.7	3.1	1.6	3.4	1.9	2.4	3.8
Baltimore	2.0	2.7	2.9	4.0	3.7	3.5	4.7
Dallas	2.8	3.5	2.1	3.2	3.1	1.5	4.6
Houston	1.5	2.8	2.8	3.7	2.7	1.9	3.2
Atlanta	2.3	3.3	1.4	3.2	2.6	3.2	2.9
Miami	1.2	3.0	2.8	4.8	4.9	4.2	4.4
Los Angeles	2.3	3.4	2.6	4.5	4.3	3.3	3.5
San Francisco	4.2	5.3	1.8	2.0	3.3	3.3	3.0
Seattle	3.0	3.6	1.5	2.9	3.7	3.9	4.1

Note: In shadow, metropolitan areas with inflation rate above average of the year.
Source: Bureau of Labor Statistics.

product market may influence inflation adjustment. Thus, it extends Bowdler and Nunziata’s (2007) temporal dimension and introduces the degree of product market competition as a new institutional characteristic that may determine the response of inflation to macroeconomic shocks.

By so doing, the study allows us to quantify the extent of heterogeneity that governs inflation dynamics across Europe. It also provides an assessment on how volatile the trajectory of inflation might be according to the product and labour market features of the economy in question, given a path for each of its macroeconomic determinants. And, finally, it points out how structural reforms targeted to the functioning of product and labour markets may shape the adjustment of inflation in response to macroeconomic shocks.

4.2. Recent stylized facts of European inflation and institutions

During the first half of the 1990s, the average inflation rate in Europe declined substantially, largely due to a nominal convergence process towards monetary integration (Chart 4.2). Yet, the process of adoption of the single currency and the actual functioning of the union under a common monetary policy framework has been accompanied by non-negligible differences in inflation rates across EMU members. The latter can be observed in the measure of within-EMU inflation dispersion, which has been persistent at around one percentage point (Chart 4.2).

In a monetary union, limited inflation dispersion is expected, due to the existence of asymmetric and idiosyncratic shocks. In addition, inflation dispersion may be the result of structural differences that prevail across member states, from the extent of openness to the institutional make-up, which would necessarily involve asymmetric inflation effects in the presence of common macroeconomic shocks.

A remarkable difference between EMU members and the states of the U.S, the other most important monetary union in the world, is not the extent of inflation dispersion, similar between monetary areas albeit slightly smaller in the U.S (Chart 4.2 & Chart 4.4), but its composition (Table 4.1 & Table 4.2). Namely, the EMU has been characterised since its establishment by a set of countries that, on the one hand, have persistently exhibited a positive inflation differential (Ireland, Greece, Spain) and a set of countries that, on the other, have persistently recorded a negative inflation differential (Austria, Germany, France) (Chart 4.1 & Table 4.1). This stylized fact leads us to infer that structural differences might be of particular relevance in the case of the EMU.

A key feature of the sample of advanced economies under consideration is its heterogeneous institutional mix. The attached charts (Chart 4.5 to 4.7) show the variety of prevailing institutional arrangements of the product and the labour markets that, on average, have characterised the OECD during the post-war period. Thus, the charts show distinctive institutional mixes such as those of Denmark, Finland, Norway and Sweden – i.e. the Scandinavian countries – which have exhibited both more coordination and unionisation than average and less product market competition, the latter with the exception of Sweden. On the other hand, the Anglo-Saxon economies of Australia, Canada, U.K, and U.S appear to have moved together in the extent of improved competition in their goods markets. Germany and Austria had the highest level of coordination over the sample period and slightly less product market competition than average. Spain is placed at an

intermediate level in terms of both coordination and competition; however, average unionisation is the weakest in the sample.¹ Ireland, on the other hand, is above average in coordination and unionisation, showing also a much worse position in the extent of product market competition if compared to most other countries. This latter feature is also shared by Portugal which, in addition, has lower coordination and higher unionisation than average.

The next section explores the potential effects on inflation adjustment of such heterogeneity in product and labour markets structures, identifying which countries might have fared relatively better after the common macroeconomic shocks of the past forty years.

4.3. An empirical model of inflation adjustment

This section presents the estimates of a dynamic fixed effects panel data model of 20 OECD countries over the period 1960-2006. The sample of OECD countries includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, New Zealand, Portugal, Spain, Sweden, Switzerland, the U.K and the U.S. We work under the assumption that the error process is uncorrelated across both country and time, and the t-ratios are calculated using the heteroskedasticity-consistent standard errors due to White (1980). The unbalanced panel data model can thus be estimated by OLS, with a total of 915 observations and just 5 observations missing. The tables (Table 4.3 & 4.4) report specifications obtained from an iterative process in which the least significant variable is deleted and the model is re-estimated until all variables are significant at either the 1%, 5%, or 10% levels.

Estimated reduced-form inflation equations typically take the linear form:

$$\pi_{it} = \gamma_0 + \gamma_1' x_{1i} + \gamma_2' x_{2i} + \mu_i + \lambda_t + \varepsilon_{it}$$

where subscript *i* refers to the country and subscript *t* refers to the year, and where inflation is explained by the vector *x*₁ of macroeconomic variables, i.e. {*inf*_{*i,t-1*}, *unemp*_{*i,t*}, *import*_{*i,t*}, *prod*_{*i,t*}, *itax*_{*i,t*}, *dtax*_{*i,t*}}, and the vector *x*₂ of interaction effects between the macroeconomic variables in *x*₁ and the institutional characteristics considered, i.e. {*COORD*_{*i,t*}, *TU*_{*i,t*}, *PMR*_{*i,t*}}.²

The model allows for cross-country variation in the intercept term, γ_0 via the fixed effects, μ_i , and it controls for common movements in inflation caused by major events, e.g. oil price hikes, via the introduction of time dummies, λ_t . All estimated equations include nine impulse dummies, i.e. they control for special events in the data, which were identified by running an AR(1) model that includes individual fixed effects and time dummies. The selection criterion consisted of identifying residuals more than four times larger than the residual standard deviation. The observations of institutional variables are normalized, i.e. demeaned from the respective sample mean, such that a value equal to zero corresponds to the sample “average” country. Import price inflation is scaled by the average degree of openness; productivity growth and direct tax growth are scaled by one minus average openness. These adjustments control for the fact that, for instance, import price inflation

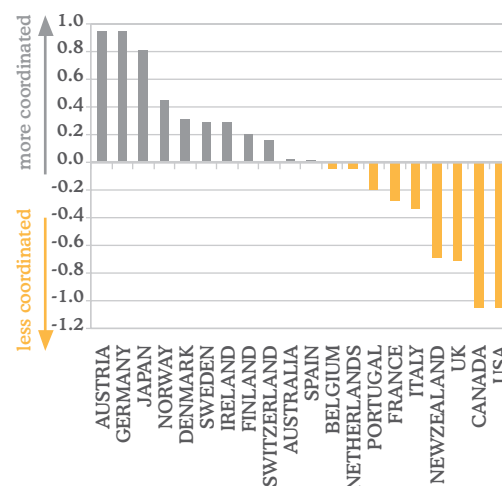
¹ For the cases of France and Spain, it is worth noting that the existing classifications on the level of unionisation are likely to underestimate the degree of union power over the labour supply. An index adjusted by the extent of bargaining coverage would, probably, be more accurate in capturing this effect for these two countries.

² {*inf*_{*i,t-1*}, *unemp*_{*i,t*}, *import*_{*i,t*}, *prod*_{*i,t*}, *itax*_{*i,t*}, *dtax*_{*i,t*}} denote, respectively, lagged inflation, the unemployment gap, import price inflation, productivity growth, indirect tax growth, and direct tax growth. See the Appendix for a description of the data.

Chart 4.5.

Average degree of labour market coordination

(in deviation from the sample mean, 1960-2007)

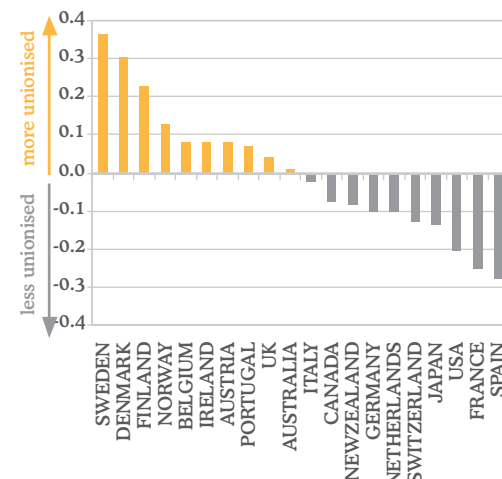


Source: ERD from Belot and van Ours (2000) and Visser (2009)

Chart 4.6.

Average degree of unionisation

(in deviation from the sample mean, 1960-2006)

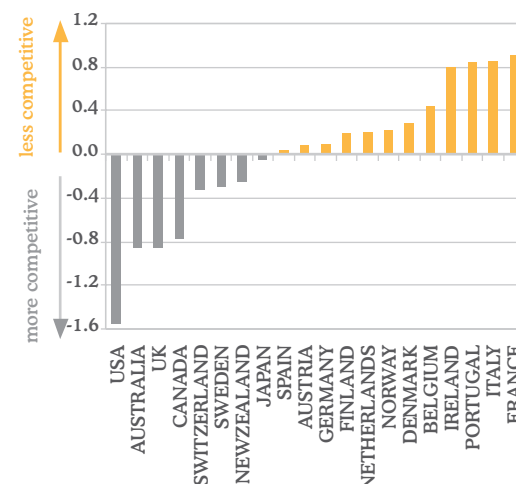


Source: ERD from Nickell and Nunziata (2001) and Visser (2009)

Chart 4.7.

Average degree of product market competition

(in deviation from the sample mean, 1960-2007)



Source: ERD from Conway and Nicoletti (2006)

Table 4.3. Inflation regressions for a panel of 20 OECD countries

(annual data 1961-2006)

	Bowdler & Nunziata (2007)		Temporal update B & N	
INF(-1)	0.52	(12.90)	0.59	(21.90)
UNEMP	-0.40	(-5.51)	-0.37	(-6.66)
IMPORT	0.33	(4.48)	0.22	(4.17)
PROD	-0.16	(-3.22)	-0.10	(-1.80)
ITAX	0.04	(6.31)	0.02	(3.15)
DTAX	0.04	(2.07)	0.02	(1.43)
INF(-1)*ZCOORD	-0.09	(-3.20)	-0.05	(-1.88)
UNEMP*ZCOORD	0.27	(2.59)	0.19	(2.18)
IMPORT*ZCOORD	-0.24	(-2.60)	-0.18	(-2.36)
PROD*ZCOORD	0.20	(2.80)	0.17	(2.59)
IMPORT*ZTU	0.55	(2.20)	0.47	(2.84)
PROD*ZTU	-0.54	(-2.84)	-0.62	(-3.00)
ITAX*ZTU	0.10	(3.64)	0.11	(3.53)
Observations	644		915	
Standard error	1.56%		1.40%	
R-squared			0.92	
AR(1)	-0.22 [0.83]		-1.46 [0.14]	
AR(2)	-0.09 [0.93]		-0.79 [0.43]	

Notes: All models include a constant, fixed effects, time dummies, and nine impulse dummies. In parentheses, t-ratios based on heteroskedasticity-consistent standard errors. AR(1) and AR(2) are test statistics for error autocorrelation up to orders one and two, respectively; p-values in square brackets. Institutional variables are preceded by Z, which indicates that they are normalised with respect to their sample mean.

Table 4.4. Inflation regressions for a panel of 20 OECD countries

(annual data 1961-2006)

	Preferred Model 1		Model 1 - Entry	
INF(-1)	0.54	(15.80)	0.53	(16.10)
UNEMP	-0.36	(-6.43)	-0.36	(-6.40)
IMPORT	0.21	(4.18)	0.18	(3.69)
PROD	-0.15	(-3.61)	-0.16	(-4.01)
ITAX	0.02	(2.54)	0.02	(2.86)
DTAX	0.03	(1.70)		
INF(-1)*ZCOORD	-0.06	(-2.28)	-0.07	(-2.44)
UNEMP*ZCOORD	0.21	(2.03)	0.18	(1.87)
IMPORT*ZCOORD	-0.16	(-2.25)	-0.15	(-2.16)
PROD*ZCOORD	0.18	(2.77)	0.17	(3.07)
DTAX*ZCOORD	0.03	(1.67)		
IMPORT*ZTU	0.42	(2.70)	0.38	(2.46)
PROD*ZTU	-0.69	(-4.13)	-0.64	(-3.58)
ITAX*ZTU	0.10	(2.89)	0.11	(3.12)
INF(-1)*ZPMR	0.05	(2.81)	0.05	(3.04)
UNEMP*ZPMR	-0.05	(-1.80)	-0.05	(-2.07)
IMPORT*ZPMR			0.06	(1.97)
PROD*ZPMR	0.10	(3.21)	0.08	(2.83)
Observations	915		920 and balanced	
Standard error	1.39%		1.39%	
R-squared	0.92		0.92	
AR(1)	-1.36 [0.17]		-1.51 [0.13]	
AR(2)	-0.69 [0.49]		-0.60 [0.54]	

Notes: All models include a constant, fixed effects, time dummies, and nine impulse dummies. In parentheses, t-ratios based on heteroskedasticity-consistent standard errors. AR(1) and AR(2) are test statistics for error autocorrelation up to orders one and two, respectively; p-values in square brackets. Institutional variables are preceded by Z, which indicates that they are normalised with respect to their sample mean. The difference between the preferred model 1 and the model with entry is that the latter focuses on a measure of entry barriers to capture the extent of competition in goods markets.

would affect domestic inflation with a larger coefficient in more open economies.³

The results show that the coefficients of macroeconomic variables have the expected sign (Table 4.4). They are usually significant at the 5% level, the exception being changes in direct taxation that may turn insignificant, or if found significant it is only at 10% level. Therefore, inflation is positively influenced by its own lag (with a persistence parameter of 0.54%), import price movements, and tax changes. It is however negatively influenced by unemployment and productivity growth.

The coefficients on the interaction terms imply that more coordination in the labour market decreases the responsiveness of inflation to lagged inflation, the unemployment gap, import prices and productivity. The presence of these interaction effects is explained by the adjustment of wages following a macroeconomic shock. A highly coordinated labour market is characterised by increased information flows among trade unions that represent different groups of workers; it is also characterised by high synchronisation in the timing of the wage bargaining process with employers. In this institutional environment, wage bargaining parties are more aware of the aggregate price effects of their individual wage demands (Cukierman and Lippi (1999), Soskice and Iversen (2000)). Hence, in the event of a changing macroeconomic environment, unions coordinate to restrain wages and thus limit the price effects of macroeconomic shocks.

On the other hand, more unionisation increases the response of inflation to import prices, indirect tax changes and productivity movements. The monopoly power over the labour supply that is associated with high unionisation rates may imply that wage increases are higher following demand-side imbalances and supply-side shocks. That is, workers may be able to extract greater labour rents in the face of labour shortages or raised living costs.

The response of inflation to supply and demand-side pressures may be potentially affected by institutional features of the product market, much in the same way that institutional features of the labour market do. Indeed, the estimates show that less competition in product markets results in a larger response of inflation to lagged inflation and unemployment, and in a lower response to productivity growth. When the measure of entry barriers is used, less competition exacerbates the responsiveness of inflation to import price inflation. The transmission channel from product market competition to inflation adjustment occurs via temporary variations in the mark-up. Hence, a more competitive product market environment induces firms to adjust their mark-ups down in response to demand-side imbalances and cost-shocks. By so doing, price-setters reduce the aggregate price rise that follows either a positive demand shock or a negative supply-side pressure.⁴

The evidence presented here indicates that both, trade unions that are highly coordinated and firms with strong wage bargaining power (a by-product of low unionisation rates), are institutional actors of the labour market that dislike large price movements in response to macroeconomic imbalances. Similarly, firms operating in a highly

³ Econometric issues relevant to the estimation of macro panel models, in particular, stationarity tests, the Nickell bias, the assumption of poolability, as well as further robustness tests, estimation with FGLS, and endogeneity issues regarding institutions are all addressed and reported in the accompanying BBVA working paper (see Correa-López *et al.* (2009)).

⁴ Notice that a level effect would also be present, as a more competitive product market is characterised by a lower mark-up than a less competitive one.

competitive product market environment dislike large price movements as an adjustment mechanism following a macroeconomic shock. Thus, as a result of the role played by the aforementioned institutions, we find large cross-country variation in inflation dynamics (Table 4.5). France and Italy show the greatest degree of inflation persistence, with a coefficient of 0.6%, while Germany and Austria are among those countries with the lowest, with a coefficient of 0.49%, Similarly, German and Austrian inflation rates are both much less responsive to the economic cycle, with a coefficient of -0.17%, while Canada exhibits the largest response, with a coefficient of -0.54%.

In order to assess the quantitative importance of the institutional environment in setting inflation dynamics, we use our estimated model to simulate the impact of a common shock on inflation. Specifically, if all countries experience a 10% rise in import prices (Chart 4.9), consumer price inflation would increase contemporaneously by 1.1% in Ireland and 0.9% in Portugal, Canada or the UK. On the other hand, German consumer price inflation would barely change. Notice that the difference in these impact effects would propagate over time since the estimated persistence parameters are different. Therefore, the cumulative effect of the shock would increase inflation in Ireland by a total of 2.5% and in Portugal by 2.3%, while German domestic inflation would be barely affected by the acceleration in import prices. It is important to note that, although the cumulated impact on inflation should be larger than the contemporaneous effect, basically due to persistence mechanisms, the shock is “temporary” in the sense that it would be soon reverted by another shock in the opposite direction. For this reason, the above macroeconomic determinants exert “temporary” effects on inflation without affecting the equilibrium or steady-state rate of inflation.

Table 4.5. Cross-country variation in inflation dynamics

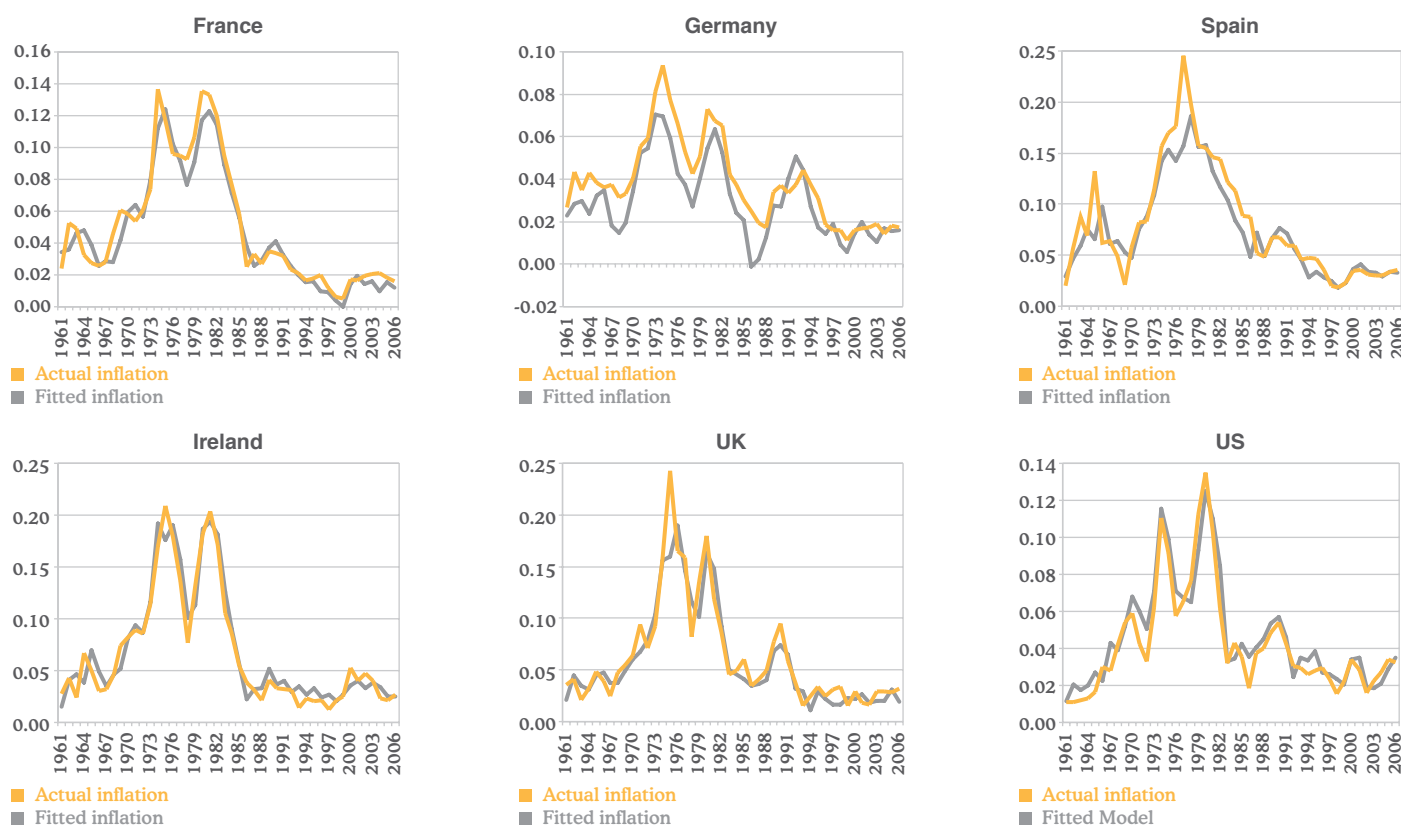
Total derivatives for inflation with respect to each macroeconomic variable (in percentage terms)

Variable	Coefficient	Absolute max.	Absolute min.
inf (-1)	0.54	0.60 (France, Italy)	0.49 (Australia, Austria, Germany, Japan)
unemp	-0.36	-0.54 (Canada)	-0.17 (Austria, Germany)
import	0.21	0.35 (Canada)	0.01 (Germany, Japan)
prod	-0.15	-0.39 (U.K.)	0.09 (Germany)
itax	0.02	0.05 (Denmark, Sweden)	-0.01 (France, Spain)
dtax	0.03	0.06 (Austria, Germany)	-0.01 (Canada, U.S.)

Notes: The estimates listed in the first column correspond to the preferred estimation. To obtain the results in the second and third columns, COORD, TU and PMR are set at their time average value for each country and then demeaned with the sample average. Absolute max refers to the largest absolute value of each coefficient. Absolute min refers to the smallest absolute value. Countries listed below correspond to the observations for which the maxima and minima occur.
Source: ERD BBVA

Chart 4.8.

Inflation rates: actual and fitted by the model, 1961-2006 (in unitary percentage terms)



Source: BBVA ERD

Chart 4.9.
Impact of a common shock to import price inflation on domestic inflation

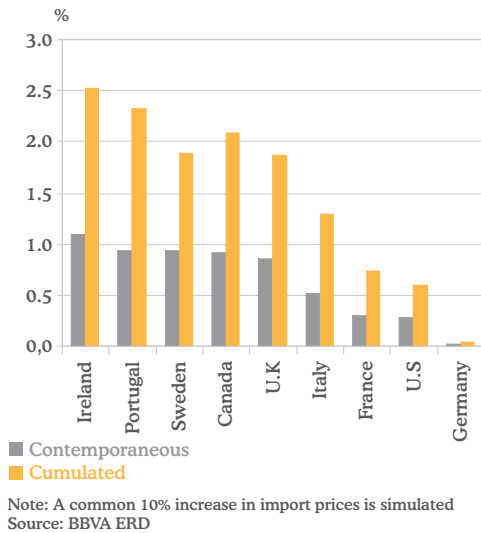


Chart 4.10.
Inflation in Ireland, 1999-2006
(unitary percentage terms)

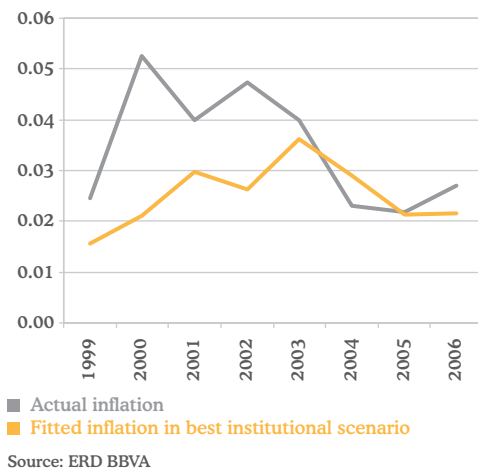
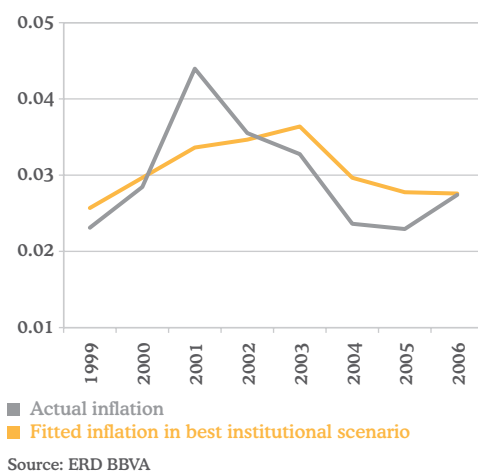


Chart 4.11.
Inflation in Portugal, 1999-2006
(unitary percentage terms)



The final simulation exercise shows the inflation rates fitted by the model had the high-inflation EMU countries - namely Ireland, Spain and Portugal - exhibited the best possible combination of institutional features since the establishment of the EMU (Charts 4.10 to 4.12). The best institutional scenario for the period corresponds to the high coordination in Germany, the low unionisation in France, and the high competition in the U.K. The results suggest that the three countries would have recorded an average annual inflation rate 0.7 percentage points below their respective fitted values, illustrating the importance of the product and labour market institutional mix as a policy objective to tackle differences in inflation.

4.4. Conclusion

There seems to be a role for product and labour market institutions in explaining the heterogeneous response of inflation to macroeconomic shocks across European countries. In particular, high coordination reduces the effect on inflation of movements in unemployment, productivity and import prices, both on impact and dynamically. Similarly, high unionisation increases the response of inflation to changes in productivity, import prices and indirect taxation. Furthermore, we have shown that product market competition decreases the response of inflation to movements in unemployment and import prices while it makes inflation more responsive to changes in productivity growth, both on impact and dynamically.

The evidence presented here suggests that an institutional environment that combines high coordination and low unionisation in the labour market with high competition in the goods market would be the most successful in achieving price stability in the event of either common or idiosyncratic macroeconomic shocks. Had the high-inflation EMU countries exhibited the best observed institutional scenario, their annual average inflation rate would have been in line with the EMU average.

Appendix

Description of the data

Variable	Definition
Inflation (inf)	Annual rate of inflation for the consumer price index.
Openness	Measured as the average ratio of nominal import expenditure to nominal GDP over the period 1960-2007.
Unemployment (unemp)	Deviation of the unemployment rate from its trend (HP-filter) level.
Import price inflation (import)	Rate of import price inflation multiplied by the openness of the country.
Productivity (prod)	Rate of productivity growth scaled by one minus average openness. Productivity growth is defined as the percentage change in output per person employed.
Indirect tax (itax)	Percentage growth rate of the indirect tax wedge.
Direct taxes (dtax)	Growth rate of direct taxes to households' current receipts scaled by one minus average openness.
Union Density (TU)	Ratio of employed union members to total employees. The feasible range for this variable is (0-1).
Coordination (COORDB)	Index (1-3) characterising the degree of consensus among the actors in the collective bargaining system. 1: low, 2:medium, 3:high.
Product Market Regulation (PMR)	Index (0-6), from least to most restrictive of competition, that measures restrictions to competition as barriers to entrepreneurship (public ownership, barriers to entry) and other restrictions (price controls, market structure, vertical integration) in domestic markets. Non-manufacturing sectors (Energy, Transport, Communications) representing around two thirds of economic activity.

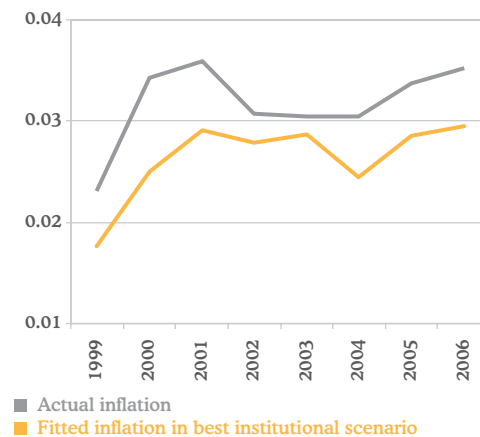
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Chart 4.12.

Inflation in Spain, 1999-2006

(unitary percentage terms)



■ Actual inflation

■ Fitted inflation in best institutional scenario

Source: ERD BBVA

5. The Lisbon Treaty: A fresh start for Europe?

Takeaways

The Lisbon Reform Treaty of the European Union (EU) will finally come into force in January 2010. In broad terms the Treaty will:

- Reform the **framework of the EU institutions** so that they can accommodate an enlarged membership. There are also changes to the way in which EU legislation is adopted and the Parliament will gain more power.
- Create a fixed **Presidency for the European Council and a High Representative for Foreign Affairs and Security Policy**. These changes will promote greater continuity and enhance the global influence of the EU.

Introduction

After several false starts, years of controversy, referendum rejections, parliamentary hiccups, and a metamorphosis in form the implementation of the Lisbon Treaty will begin next year. The Treaty amends the previous morass of agreements and amendments which have guided the development of a community that began with 6 nations in 1957 to a union of 27 (28 by the end of next year when Croatia is expected to join). With political goodwill (and a little luck) it will streamline the institutions and decision making procedures for an EU and open a new era of European cooperation.

It is expected that the Treaty will make the institutions of the EU more responsive and solve the 'democratic deficit'. The European Commission (which has the power to initiate legislation) will become more flexible and less unwieldy. The European Council for Heads of Government will have a permanent President and the Council of Foreign Ministers will have a High Representative for Foreign Affairs. Collectively these reforms should give the deliberations of these Councils more continuity and an enhanced political direction. The European Parliament will have a bigger voice in decisions to make the process more democratic. And all the institutions should now work more efficiently together.

It is not the new start which some had hoped for when a European Constitution was originally proposed and fails to provide the Union with a flag, anthem or other symbols of 'nationhood'. But it is a very significant reform to the EU – and almost certainly the last for at least a generation.

Reformed institutions, improved cooperation

The European Parliament has 750 members and is the directly elected EU institution that represents the citizens of the Member States. Parliaments – both national and the European – will have new powers to scrutinise and control the executive powers of the EU. This will go some of the way to plugging the gap in Europe's 'democratic deficit' – the perception that EU rules are made by people who have no real mandate. And for the first time, there will be a mechanism for the citizens of Europe to influence directly the work of the Commission.

- **Co-decision making between the Council and the Parliament** is considerably expanded. Co-decision making is the term for the European Parliament's power to make laws jointly on an equal footing

with the Council of Ministers. The intention of the co-decision procedure is to enhance the democratic legitimacy of the EU: decisions will now require the majority support of both MEPs and the Member States as represented by their Ministers in the Council. It will now be the method used to make most laws and become what is known as 'the ordinary legislative procedure' for the EU. This means that the influence of the Parliament is extended into areas like justice and home affairs (currently 'third pillar' issues in the EU jargon), agriculture, fisheries, structural funds so that it will become an equal co-legislator for 95% of European legislation. Where Parliament and the Council fail to agree on a proposal it will fall – neither institution will be able to prevail over the other.

- **National Parliaments are given a 'yellow card'** – in addition to the competence of the European Parliament being extended, national Parliaments will also acquire new powers. First, they will be given more time – raised from six to eight weeks - to scrutinise draft legislation coming out of Brussels. Secondly, they will be given a 'yellow card' to stop proposals which breach the principle of 'subsidiarity' (the rule which states that the EU can only take action where it will be more effective than action taken at a national, regional or local level: it effectively prevents the EU from interfering in areas which belong to Member States). If a third of national Parliaments object to a Commission proposal, the Commission must reconsider the measure. And where a simple majority of national Parliaments continue to object, the matter must be decided by the Council and European Parliament who hold the 'orange card' to halt the process or push on. The yellow/orange card mechanism looks awkward on paper and will probably be even clumsier in practice. Nevertheless, it adds to the stock of 'checks and balances' to ensure that the EU moves with majority opinion and does not become the 'federal superstate' feared by some.
- **The right of the citizens' initiative** will give the people of Europe the right to have a say directly in the work of the Commission. Where more than 1 million people in a significant number of countries request that the Commission take action, there must be formal response to do so. In an age of virtual communities springing up from the web 2.0 this could become an increasingly influential mechanism in the years to come.

The European Commission is the only EU institution with the general power to initiate proposals for legislation. It also implements the EU's programmes and enforces its' rules. Under the Lisbon Treaty it will become a leaner organisation with fewer members, more orientated towards promoting the interests of the EU and less a forum for the representatives of the individual Member States. It will also become further integrated with the other institutions so that the High Representative for Foreign Affairs will be a Vice President of the Commission and chair the meetings of the Foreign Ministers in the Council.

- There will (eventually) be **fewer European Commissioners than before**. In the new Commission (which will be announced soon) each of the 27 Member States will continue to have one Commissioner. In theory, European Commissioners are supposed to be impartial servants of the EU, not representatives of their Member State, so there should not be a problem. In reality, some countries may find it hard to adjust to the idea that they have no direct representative in a powerful EU institution.

- The **High Representative for Foreign Affairs** will be both a Vice-President of the Commission and will chair the meetings of the General Affairs and Foreign Relations Council – the regular meetings of the Member States' Foreign Ministers. Foreign policy remains a (jealously guarded) competence of individual Member States and up to now the work has also been split between a European Commissioner for Foreign Affairs and the European Council's High Representative. Merging the two posts should ensure much greater coordination between the foreign policy preferences being expressed by the individual EU countries and the foreign policy work of the Commission. In addition, the new High Representative will also be head of a new European External Action Service (EAS) made up of national civil servants, staff from the Council secretariat and Commission officials. Like the President of the Council (see below) the way in which this post evolves will depend on the personality and charisma of the new High Representative - and their capacity to use the EAS efficiently. It will be a highly demanding job for whoever gets it: in the first year there will be over 260 summits or meetings to attend so it will be a test of stamina if nothing else. Establishing a good relationship with the Foreign Ministers of the Member States to avoid bruised egos and squashed toes will be essential. And nursing the Parliament will also be important as the EAS will be funded from the EU budget – over which MEPs will have significant control.
- The **European Commission** must be approved by a majority in the European Parliament – as now. Jose Manuel Barroso has recently been re-elected President by the Parliament which must now approve the other nominations for the Commission as a whole. The Parliament may ask the Member States to reconsider nomination of particular individuals - as it did in 2004 in the case of Italian candidate for Commissioner, Rocco Buttiglione, whose view that homosexuality was a 'sin' did not chime well with the Parliament. Or it may dismiss an entire Commission as it did in the case of the Santer administration in 1999. However, under the Lisbon Treaty, this process will now extend to the new High Representative for Foreign Affairs who will be a vice President of the Commission. In theory at least this should give the Parliament some control of the nascent moves to create a common foreign and security policy (or CFSP as it is known in the jargon of the EU).

The European Council gives the EU its political direction and sets the priorities. It is made up of the most senior elected politicians from the Member States – the Presidents and Prime Ministers who hold executive powers. In place of the current 'rotating' presidency where each Member State gets a six month turn - Spain will be next, from January to June 2010 - the European Council will get a permanent President. Other departmental ministers (such as agriculture or transport) meet their counterparts in the Council of the European Union - better known as the Council of Ministers. These will continue to be chaired by whichever country holds the six month presidency but there will be new rules for voting.

- A new **permanent President of the European Council** - chosen by the Heads of Government - will both chair the meetings and direct its work. The current 'rotation' system makes continuity and coordination difficult but this should be solved by having a permanent President in place to chair and oversee the work of the Council. The President will also report back to the Parliament after each Council meeting. (the permanent High Representative will chair The

General Affairs and External Relations Council of Foreign Ministers – see above)

- **Qualified Majority Voting** – or QMV as it is popularly known - will become the general rule for the decision making process in the European Council. The intention is to ensure that any new legislation is supported by a broad consensus. A qualified majority is one in which a double majority will be needed: a measure can only be passed if it is approved by 55% of the member states collectively representing 65% of the population. This means legislation can only be passed if there is a coalition of large and small member states in favour (preventing domination of the EU by the big countries). A minimum of four member states will be needed to for a blocking minority. In addition a mechanism known as the 'l'onnina compromise' provides that a minority of member states can ask for a reconsideration of a legislative proposal before its adoption. The new rules will be phased over a three year period starting from 2014 so until 2017 measures can still be blocked by procedures under the existing rules. The economic competences of the EU – mainly related to the single market – are already decided by QMV so there is no change in this area.

It is evidently too soon to calculate the effect of the Lisbon Treaty on the European economy. In theory QMV may speed up decision making in the Council but in practice it is a body which always prefers consensus to contentious votes and in any event economic issues are already decided by QMV. On the other hand, the co-decision procedure with the Parliament could slow the legislative process – and any painful economic reform.

In any event, other factors could be more influential in the short term. Existing Commissioners such as Neelie Kroes (Competition), Charlie McKreevy (Internal Market) and Joaquin Almunia (Economy) will move on when the current Commission ends in February 2010. Their successors are unlikely to be more pro-market and there is a real risk that they may be less so. There is also the very important renegotiation of the Lisbon Agenda (not to be confused with the Treaty) to enhance productivity in the European economy. Agreed in 2000, the Agenda provided a basis in principle for product and labour market reform and greater investment in R&D. Much of it hasn't happened in practice and finding consensus for the next round of reform will be a major challenge for the Spanish Presidency in the first half of next year.

6. Summary of Forecasts

Germany: GDP growth and inflation forecasts

YoY rate	2005	2006	2007	2008	2009	2010
Private consumption	0.4	1.4	-0.3	0.2	0.2	-0.1
Public consumption	0.4	1.0	1.7	2.0	2.6	1.8
Gross Fixed Capital Formation	1.1	8.6	5.3	2.3	-8.6	1.2
Inventories (*)	-0.8	-0.4	-0.2	0.5	-0.3	0.2
Domestic Demand (*)	0.1	2.2	1.0	1.5	-1.5	0.7
Export	8.0	13.4	7.8	2.4	-15.2	3.8
Import	6.9	12.2	5.0	3.9	-9.6	4.2
Net export (*)	0.8	1.1	1.6	-0.5	-3.5	0.0
GDP	0.9	3.4	2.6	1.0	-5.0	0.7
Inflation	1.9	1.8	2.3	2.8	0.2	0.6

(*) Contribution to growth
Source: BBVA

France: GDP growth and inflation forecasts

YoY rate	2005	2006	2007	2008	2009	2010
Private consumption	2.5	2.6	2.4	1.0	0.4	0.5
Public consumption	1.2	1.3	1.5	1.1	1.8	1.6
Gross Fixed Capital Formation	4.5	4.4	6.5	0.4	-7.0	-2.0
Inventories (*)	0.1	-0.1	0.0	-0.5	-1.1	0.2
Domestic Demand (*)	2.8	2.8	3.2	0.7	-2.7	0.5
Export	3.4	5.0	2.5	-0.6	-11.2	3.0
Import	6.3	5.9	5.4	0.6	-10.6	2.5
Net export (*)	-0.9	-0.4	-0.9	-0.4	0.1	0.1
GDP	1.9	2.4	2.3	0.3	-2.6	0.6
Inflation	1.9	1.9	1.6	3.2	0.1	0.7

(*) Contribution to growth
Source: BBVA

Italy: GDP growth and inflation forecasts

YoY rate	2005	2006	2007	2008	2009	2010
Private consumption	1.1	1.2	1.2	-0.9	-1.9	0.5
Public consumption	1.9	0.5	1.0	0.6	1.6	1.0
Gross Fixed Capital Formation	1.4	3.2	1.6	-2.9	-12.9	-0.7
Inventories (*)	-0.4	0.5	0.0	-0.3	-0.3	0.0
Domestic Demand (*)	1.0	2.0	1.3	-1.3	-3.8	0.3
Export	2.0	6.5	4.0	-3.7	-21.0	2.0
Import	2.7	6.2	3.3	-4.5	-16.5	2.4
Net export (*)	-0.2	0.1	0.2	0.2	-1.2	-0.1
GDP	0.8	2.1	1.5	-1.0	-5.0	0.2
Inflation	2.2	2.2	2.0	3.5	0.8	1.1

(*) Contribution to growth
Source: BBVA

Spain: GDP growth and inflation forecasts

YoY rate	2005	2006	2007	2008	2009	2010
Private consumption	4.2	3.8	3.6	-0.6	-5.4	-1.7
Public consumption	5.5	4.6	5.5	5.4	4.1	1.1
Gross Fixed Capital Formation	7.0	7.2	4.7	-4.4	-15.3	-7.5
Equipment	9.2	10.2	10.0	0.9	-12.3	-4.2
Construction	6.1	5.9	3.8	-4.0	-9.6	-2.7
Other products	7.1	7.1	3.9	4.1	0.6	1.0
Inventories (*)	-0.1	0.4	-0.1	0.1	0.0	0.0
Domestic Demand (*)	5.3	5.5	4.4	-0.5	-6.8	-2.9
Export	2.5	6.7	6.7	-0.9	-13.9	0.5
Import	7.7	10.2	8.0	-4.8	-20.4	-4.9
Net export (*)	-1.7	-1.4	-0.9	1.4	3.0	1.7
GDP	3.6	4.0	3.6	0.9	-3.8	-1.2
Inflation	3.4	3.5	2.8	4.1	-0.4	0.9

(*) Contribution to growth
Source: BBVA

United Kingdom: GDP Growth and inflation forecasts

YoY rate	2005	2006	2007	2008	2009	2010
Private Consumption	2,2	1,5	2,1	1,0	-3,2	-0,2
Public Consumption	2,0	1,6	1,2	2,7	1,8	1,5
Gross fixed capital formation	2,4	6,5	7,8	-3,3	-13,4	-2,8
Inventories (*)	0,0	0,0	0,1	-0,4	-1,3	0,5
Domestic Demand (*)	2,2	2,4	3,1	0,1	-5,3	0,2
Export	7,9	11,3	-2,8	1,0	-11,7	1,9
Import	7,1	8,8	-0,7	-0,8	-12,9	0,8
Net Export (*)	0,3	0,4	-0,6	0,5	0,7	0,3
GDP	2,2	2,8	2,5	0,7	-4,6	0,5
Inflation (avg)	2,0	2,3	2,3	3,6	2,0	2,1

(*) Contribution to growth

Euro area (YoY)

	2003	2004	2005	2006	2007	2008	2009	2010
GDP at constant prices	0.8	1.9	1.8	3.1	2.7	0.6	-3.9	0.2
Private consumption	1.2	1.5	1.9	2.1	1.6	0.3	-0.9	0.2
Public consumption	1.7	1.6	1.6	2.0	2.2	2.1	2.5	1.9
Gross Fixed Capital Formation	1.2	1.9	3.4	5.8	4.8	-0.6	-10.3	-1.5
Inventories (*)	0.2	0.2	-0.1	0.1	-0.1	0.1	-0.5	0.2
Domestic Demand (*)	1.5	1.7	2.0	3.0	2.3	0.5	-2.8	0.4
Exports (goods and services)	1.3	6.9	5.3	8.5	6.1	1.0	-14.5	2.0
Imports (goods and services)	3.2	6.5	6.0	8.4	5.2	1.0	-12.4	2.4
External Demand (*)	-0.6	0.2	-0.2	0.1	0.4	0.0	-1.1	-0.1
Prices and Costs								
CPI	2.1	2.1	2.2	2.2	2.1	3.3	0.3	0.8
CPI Core	2.0	2.1	1.5	1.5	2.0	2.4	1.3	0.7
Labour Market								
Employment	1.1	0.9	1.9	2.0	2.0	1.1	-1.7	-1.0
Unemployment rate (% of labour force)	8.8	9.0	9.0	8.4	7.5	7.5	9.5	10.9
Public Sector								
Surplus (+) / Deficit (-) (% GDP)	-3.1	-2.9	-2.5	-1.3	-0.6	-2.0	-6.6	-7.2
External Sector								
Current Account Balance (% GDP)	0.3	0.8	0.1	-0.1	0.1	-1.1	-0.8	-0.3

* Contribution to growth

International environment (YoY)

	Real GDP growth (%)				Inflation (%)**			
	2007	2008	2009	2010	2007	2008	2009	2010
US	2.1	0.4	-2.5	1.5	2.9	3.8	-0.6	1.1
Japan	2.3	-0.7	-5.3	1.1	0.5	1.0	-1.5	-0.3
Latam***	5.7	4.0	-2.5	3.5	5.8	8.1	5.6	7.1

** Inflation forecast: end of period

*** Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela

Financial variables (end of period)

	Official rate (%)				10 year interest rate (%)			
	11/23/09	Dec-09	Jun-10	Dec-10	11/23/09	Dec-09	Jun-10	Dec-10
Euro zone****	1.00	1.00	1.00	1.00	3.30	3.30	3.40	3.50
US	0.00	0.00	0.00	0.00	3.40	3.40	3.30	3.60

	Exchange rate (vs euro)				Brent			
	11/23/09	Dec-09	Jun-10	Dec-10	11/23/09	Dec-09	Jun-10	Dec-10
US	1.48	1.48	1.42	1.35	\$/b 78.2	60.6	67.3	68.3

**** 10 year interest rate refers to Germany bonds

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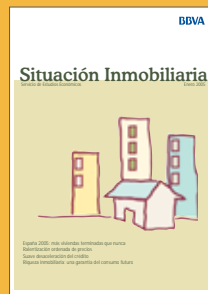
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