BBVA Research

Europe

Economic Outlook

First Quarter 2011

Economic Analysis

- The sovereign debt crisis has had a surprisingly reduced cost in terms of growth, thanks to strong foreign demand.
- The economic recovery will go on at a moderate pace, with continued divergence across countries.
- Peripheral countries have embarked in sharp consolidation and structural reforms, which must be sustained over time.
- A carefully designed reform of governance in Europe is key to dispel financial strains.
- ECB will maintain its loose monetary policy, as second round effects on inflation are small.

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Closing date: February 15, 2011

Editorial

Last year was a difficult one for the eurozone, despite the recovery in economic activity. Financial tensions from preceding years extended on to sovereign bonds, sparked by the Greek crisis. After the reaction of European authorities in May 2010, the creation of the European Financial Stability Fund (EFSF) and a temporary break from financial tensions brought about by the bank stress tests in the summer, Europe experienced a second wave of financial strains after the summer, as doubts about Irish banks pushed the country into a rescue program. In the middle of this turmoil, doubts raised by declarations of some European leaders on the possibility of making investors carry some of the costs of the eventual sovereign debt restructuring made things worse.

In both episodes, the threat of contagion amongst periphery countries has been a central factor. In fact, the main fear that has hovered around the eurozone during 2010 has been the possibility that one of the large countries (Italy or Spain) would be dragged into a rescue, propagating contagion on a systemic scale into the European financial system, and possibly extending beyond Europe. Thankfully, this risk has been significantly reduced due to the reaction countries and from authorities at December's European Council, which established the EFSF as a permanent rescue mechanism. Moreover, next March's Council was put as a deadline for the approval of further crisis resolution procedures to reinforce the steps taken so far. In our view, the approval of an adequate framework of governance measures will be critical to dispel the risks that trouble the recovery. As we highlight in section 3.3, it is important to make clear that all solvency issues in peripheral countries will be solved, and that the design of a future crisis resolution mechanism does not imply the participation of investors in an eventual rescue program in the short term, so as not to exacerbate market uncertainty. Recent discussions raised by Germany on a reform package to enhance competitiveness are also useful for long-term growth, but European authorities must keep their focus on those key issues regarding governance.

The sovereign crisis has had a surprisingly reduced cost in terms of low economic growth, partly thanks to strong exports to emerging markets. German GDP growth has been very high (3.5%), thanks to foreign demand but also to a substantial rebound effect. French and Italian performance has also been better than expected. As a whole, eurozone economic growth amounted to +1.7% in 2010, and it is forecasted to be similar in 2011 and 2012, as the recovery is still seen as slow due to multiple uncertainties. We also expect domestic demand to have a greater role this year, easing the burden off exports, but a resolute recovery of private consumption is far from certain (Section 2).

The ECB's role has been crucial so far in facing liquidity problems in the financial system, given that many markets have remained closed. Although the ECB is eager to return to normality and leave this role as soon as possible, it should not give in to abandoning extraordinary measures too quickly (Box 1). Likewise, even if inflation will remain above the 2% threshold for a few months, due to energy price hikes, we do not think it will be necessary to raise official interest rates too early, as second round effects on inflation are not likely to be significant (Box 2).

All in all, the recovery will be slow, uncertainties are still present, but the worse seems to be over. This does not mean that problems are solved: reform efforts must continue in the periphery, and institutional reforms at EU level have to be properly designed.

1. Drivers of economic activity in the eurozone

The eurozone has been subject to strong forces during the past months that have resulted in ongoing growth, but with differences among countries. These drivers come from still strong foreign demand from emerging countries, an ongoing financial crisis that has subsided somewhat more recently, the movements of the euro and the policy framework, with lax monetary policy but stricter fiscal policy in periphery countries. We look at these factors in turn.

Global economic growth continues to be strong

After closing 2010 with a growth rate of 4,8%, the global economy is expected to decelerate slightly to 4,4% both in 2011 and 2012, a better performance than what could have been anticipated 12 months ago. This is explained by a better outlook for advanced economies, due to (i) the better growth expectation for the US after the fiscal stimulus, and (ii) a strong performance in core European countries. Overall, the pattern of global economic growth remains broadly unchanged as the real engine of dynamism continues to be the emerging world, led by Asia (China and India in particular, Chart 1), and developed economies continue losing ground.

Over last quarter of 2010, it seemed clear that the US was not falling into a double dip. There are, at least, four main factors that have contributed to this change. First, in general terms, data released over the last few months has come out better than expected; in particular consumption was more resilient than feared. At the same time, the labour market has been improving, albeit at a slow pace. Second, the Federal Reserve took decisive action by implementing an additional round of asset purchases (QE2) amid concerns over the pace of the American recovery, which provided support for bond prices in particular and asset prices in general. Third, uncertainty about increased regulation and taxation has decreased, boosting business confidence and thus most likely investment in 2011. Finally, and perhaps more important, a new fiscal stimulus package approved at the end of 2010 will provide a significant boost to economic growth in 2011 and 2012.

Emerging economies in Asia and Latin America continue growing strongly, leading the global recovery and the decoupling from advanced economies. In both regions domestic demand remains strong and is the main driver of growth, as policies remain highly accommodative (even as fiscal stimulus is withdrawn, except in China), the inventory cycle ends and external demand weakens (except for Latin America, where high commodity prices are also supporting the dynamism of economic activity). Although GDP outturns at the end of 2010 were higher than expected (thus raising our estimate of 2010 growth) in our opinion GDP growth in 2011 and 2012 should not deviate significantly from our previous forecasts.

Spillovers from financial strains to economic activity have been limited so far, even in peripheral countries

Since October 2010, financial tensions in Europe have surged again (Section 3.1), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses resurfaced again, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions after the summer was triggered by two events. First, markets were uncertain about the ability of European institutions to deal with sovereign debt crises. Private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013, and the likelihood that haircuts on existing debt would be needed to restore fiscal sustainability. The second trigger was increasing doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. These two triggers developed amid the background of concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable. The fragility of the recovery in financial markets right after the summer highlights that markets are increasingly focusing on sovereign solvency problems in some countries, rather than just liquidity concerns.

As pointed out above, financial spillovers from this recent episode have been rather limited, including to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to very positive outturns in Germany and other core European countries (Section 2). However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed soon and countries do not continue pushing economic reforms to reduce fiscal vulnerabilities, restructure the financial system and increase potential growth. What is agreed at the next European Council in March will be key in this respect (Section 3.3).

Downward pressures on the euro thanks to the growth divergence between the US and EMU

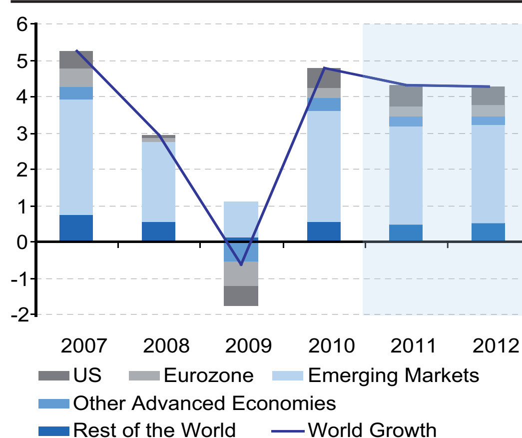
The pull effect of stronger global demand was complemented by a more depreciated euro than anticipated three months ago. The relatively more hawkish approach by the ECB to possible inflation risks (as compared to the Fed) together with a slight reduction in financial risk prompted by the sense of more action on the part of European authorities induced an appreciation of the euro vis-à-vis the dollar at the end of January (Chart 2). Going forward, and once these two factors are out of the picture (together with the end of QE2) we should go back to more fundamental factors driving euro-dollar exchange rates. They will depend more on relative growth prospects (which favor the US vis-à-vis EMU) but also on the relative perception of monetary policy in both areas and the evolution of investment flows.

Highly accommodative monetary policy but restrictive fiscal policies

The divergence between growth in advanced and emerging economies will continue to induce markedly different macroeconomic policies going forward. Monetary policies will remain highly accommodative in the US and Europe, fuelling a search for yield elsewhere (in emerging markets and increasingly in commodities as well). An accommodative monetary policy in the eurozone is crucial to prompt an auto-sustained recovery in the short-run, easing the financial burden of both private and public sectors (Box 1). At the same time, signs of overheating are starting to emerge in some Asian and Latin American countries, pushing authorities to consider tightening policy faster than previously envisioned given incipient inflationary pressures, especially in Asia. On the fiscal side, policy has been broadly balanced in Germany, France and Italy (which postponed most of the structural adjustment to this year), and restrictive in the periphery, with countries approving extraordinary measures during the year to face the pressure from financial markets. This has resulted in diverging growth rates across both groups of countries.

Chart 1

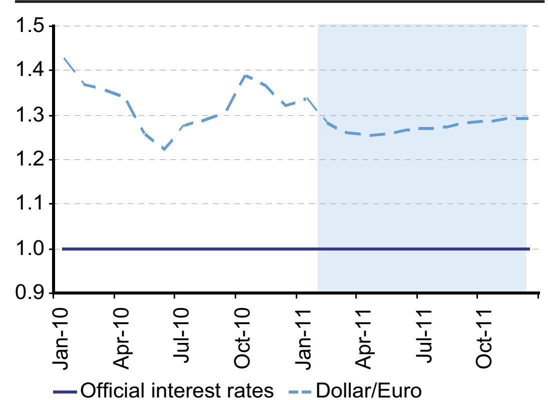
Global GDP growth and contributions



Source: BBVA Research

Chart 2

EMU: official interest rates and dollar-euro exchange rate



Source: Datastream and BBVA Research

Box 1: Monetary policy: trying to focus on just one issue

During the last few months, the approach to monetary policy taken by the Fed and the ECB diverged. On the one hand, the Fed continued to focus on how to provide more stimulus and implemented QE2 in early November, showing its resolution to promote a stronger pace of economic recovery and to address the tail risk of deflation –which has subsided significantly–. Even the Bank of England was biased in the same direction, despite inflation running above its target. On the other hand, the ECB was leaning towards continuing with its gradual phasing-out of the full-allotment liquidity provision. A halt in this strategy became necessary as sovereign debt stress soared once again after the lack of consensus to resolve liquidity and solvency problems.

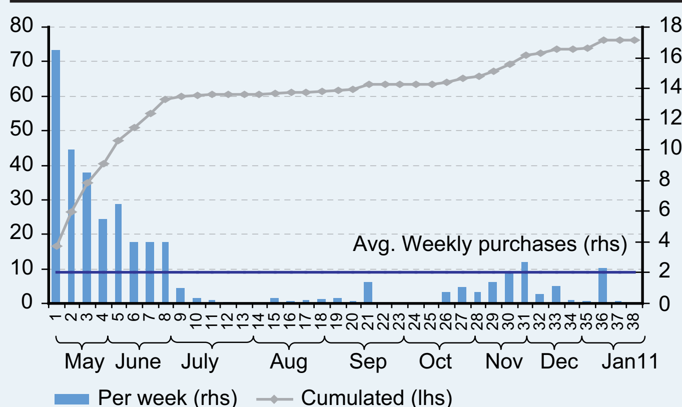
With the aim of reducing tensions in bond markets, the ECB showed a flexible approach at its December meeting: 1) It announced a delay of its “exit strategy” –the full-allotment for the 3m LTROs supply of liquidity was extended until March 2011–; and 2) it stepped up its bond purchases showing that the Securities Market Program (SMP) was “still ongoing” (Chart 3). These decisions achieved its goal of stopping the deterioration process which was becoming self-reinforcing. This showed that the dependence of peripheral countries on the ECB was increasing, but at the same time it reflected that the situation was beyond the control of the ECB, i.e. the non-standard measures put a ceiling on risk-premia but did not cause a reversal as solvency concerns remained.

From then on, the ECB has stressed the need for the EFSF to be improved both on a quantitative and qualitative basis, which shows that the ECB is increasingly uncomfortable buying bonds and expects a solution on the debt issues from euro area countries policy makers so it can focus fully on its inflation mandate. Accordingly, it has increased its pressure on European authorities to improve the stabilization fund in both quantity and quality, with the latter meaning “having a tool as flexible as possible”, i.e. the possibility of directly buying bonds. Regarding full allotment, the ECB has been warning on the issue of “addictive banks” which should not delay the necessary adjustments (reduce their financial leverage and strengthen their capital, Chart 4). The ECB might be thinking of special measures to be implemented once the full allotment is withdrawn to prevent more dependent banks from affecting auction results. Nonetheless, a proper functioning of money markets seems still far away and the unlimited liquidity remains essential to the proper transmission of monetary policy. Thus, the flexible approach from the ECB is sensible.

Lately, the ECB’s communication has focused on one goal: anchoring inflation expectations, once inflation figures surpassed 2% and marginally surprised market forecasts. On the one hand, it has adapted its wording –with a more hawkish tone– to a context of higher inflation risks. On the other hand, it has stressed its emphasis on the “separation principle” between monetary policy and non-standard measures. By clearly stating that there are no implications for policy arising from the divergence between the ECB’s improving macroeconomic assessment and its views on financial stability/ sovereign issues, the ECB gains enough flexibility to act on either front and indicates that it stands ready to act on inflation no matter what the circumstances are. A more hawkish than expected tone caused in January a market response and expectations of rate hikes were brought forward. Nonetheless, at its February meeting, although the ECB maintained its hawkish tone, it was not hardened further and it was cautious trying not to sound more concerned about inflation. In response, futures dropped somewhat.

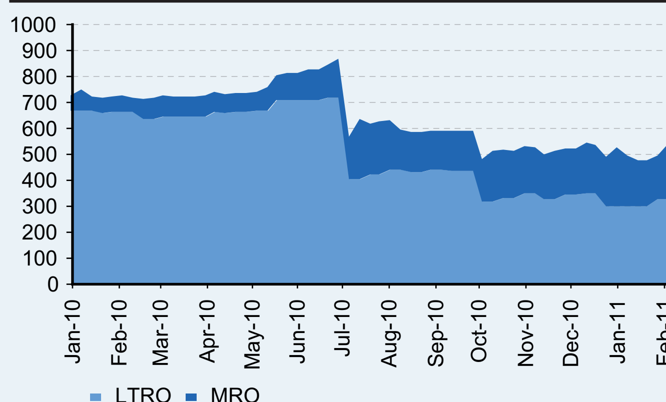
What can be expected? It is clear that the ECB is now focused on inflation, but is still keeping an eye on liquidity and the dysfunctional performance of some market segments. Yet, unless inflation expectations become unanchored elevating the risks of second-round effects –which is improbable–, rate hikes continue to be unlikely in the medium-term (during this year). Moreover, upside risks on inflation have to be weighed against the worries regarding peripheral countries. Although a sense of urgency to address these issues seems to be now in place, if authorities’ resolutions come short of what is needed the peripheral debt situation could deteriorate once more. Therefore, two elements will likely condition the ECB’s decisions: 1) the expected enhancements to governance (in March European Council meeting); and 2) the stress-tests results (in June). Favourable outcomes in both would allow the ECB to focus fully on its inflation mandate.

Chart 3
ECB: sovereign bond purchase program



Source: ECB

Chart 4
ECB: lending to EMU credit institutions (€bn)



Source: Datastream and BBVA Research

2. Recent trends and projections

2.1. Eurozone

Eurozone recovery slowed in Q3 and remained broadly stable in Q4

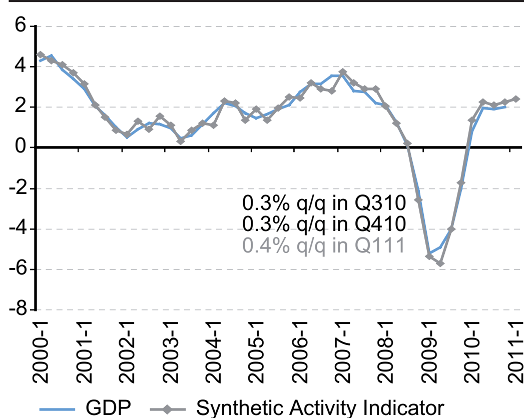
The eurozone economy experienced a short-lived deceleration in the third quarter, due mainly to seasonal factors, with economic activity remaining broadly stable in the last quarter of the year, in contrast with expectations of a marked slowdown over the second half of 2010 that we anticipated three months ago. According to Eurostat flash estimate, GDP increased by 0.3% q/q in the last quarter of 2010, against our forecast estimation of +0.5% q/q (Chart 5). This ongoing growth was determined by global demand resilience, which supported eurozone exports, but offset by the weather-related decline in construction investment.

Scarce data available so far for the first quarter of 2011 provide mixed signs. While confidence data from PMI surveys continue to suggest that economic activity might have accelerated once again, data from the European Commission are somewhat less upbeat, as they give more evidence that the recovery of household consumption is still hesitant. In any case, both surveys support our view of continued economic growth in the first quarter (0.3% q/q with still very limited information). If the slowing of growth in Q4 is confirmed to be temporary, we could even expect a stronger rebound for the beginning of the year

Aggregate macroeconomic data, however, conceal large differences between member states, showing economic growth was not widespread. Countries in core Europe continued growing, while output in the periphery contracted, or remained flat. According to national GDP flash estimates, Germany continued to lead the monetary union (+0.4% q/q), followed by France to a lesser extent (+0.3% q/q), whereas GDP decelerated somewhat in Italy (+0.1% q/q). Regarding non-core countries, economic activity both in Spain (+0.2% q/q) and Ireland probably stagnated or barely increased, whereas in Greece (-1.4% q/q) and Portugal (-0.3% q/q) declined. The decoupling can be fundamentally explained by the negative impact of domestic demand evolution, brought about by the need to address fiscal and other important macroeconomic imbalances generated in the expansion stage of the cycle (Chart 6).

Chart 5

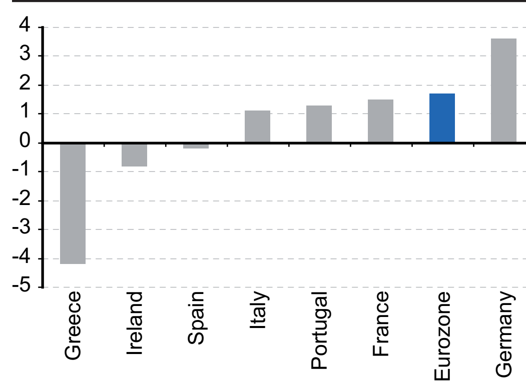
Eurozone: Synthetic activity indicator (% y/y)



Source: Eurostat and BBVA Research

Chart 6

GDP growth by countries in 2010 (annual average growth, %)



Source: BBVA Research

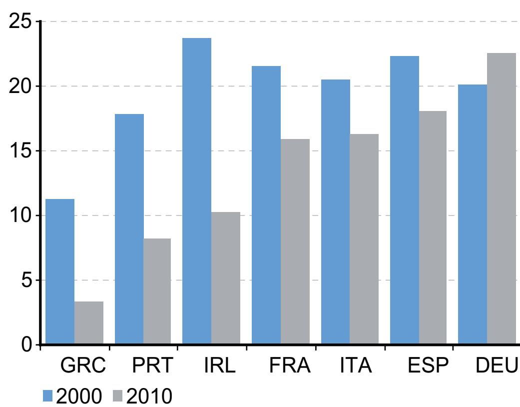
Private consumption resilient, but not giving signs of a decisive recovery

Private consumption returned to positive quarterly growth rates in late 2009, supported by improved consumers' expectations on the economic recovery and labour market performance. This sentiment was reflected in the decline of savings (Chart 7), especially for precautionary reasons, in a context of households without excessive leverage problems at the aggregate level. Nevertheless, over the second half of the year, households' spending growth remained relatively stable as the unemployment rate stabilized at high levels and led to very weak growth in nominal wages, while inflation rebounded (Chart 8). In addition, despite low interest rates, loans to households grew at moderate rates due to the tightening of credit conditions. Some of the fiscal adjustment measures carried out in various countries

also induced consumers to anticipate part of their large purchases in the first semester, explaining to a larger extent the slight deceleration of household consumption in the second half of the year. Retail sales data in the last quarter of 2010 confirm the same outlook, falling slightly from the previous quarter.

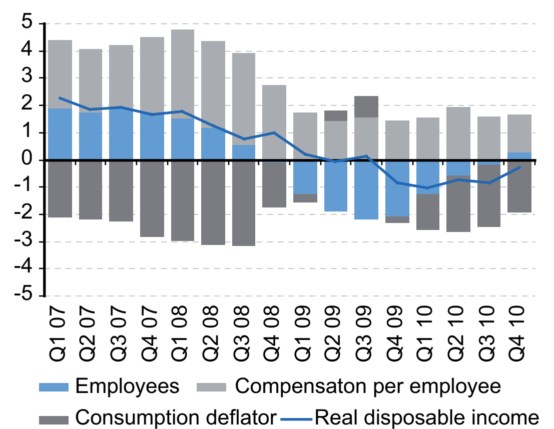
Overall, preliminary figures show that household consumption in the eurozone recorded moderate growth in 2010 (+0.7% y/y), after the fall registered in the previous year (-1.0% y/y). Consumption was higher in Germany and France in the second half of the year, driven by better fundamentals and lesser deterioration of the labour market. In these countries, particularly in Germany, surveys point towards a rebound in private consumption, though they still have to be confirmed by hard data. In the case of peripheral countries, private consumption contracted mainly in the second half of the year due to negative effects of strict fiscal austerity measures, such as VAT increases. The effect of these measures was reinforced by the long-term need for de-leveraging of households in many of these countries.

Chart 7
Saving rate (% of GDP)



Source: AMECO and BBVA Research

Chart 8
Eurozone:
Household disposable income (% y/y)

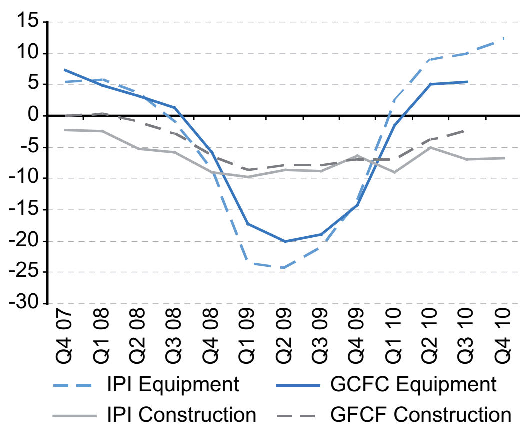


Source: ECB and Eurostat

The clear recovery of investment in capital goods did not offset the fall of the construction sector

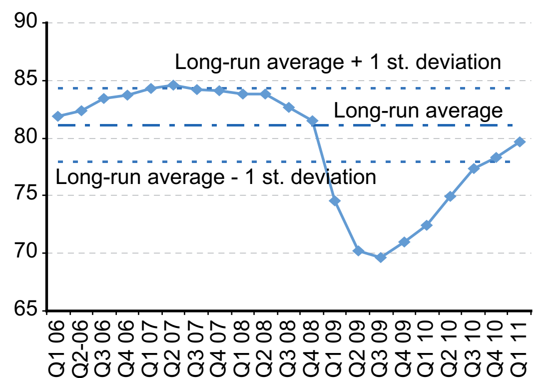
The impulse received from exports on equipment investment observed since mid-2009 resulted in this item growing at an accumulated +6.0% up to the third quarter. November industrial production data on capital and intermediate goods suggest that this trend continued into the last quarter of the year (Chart 9). However, gross fixed capital formation on aggregate terms has been dragged back by the strong fall in investment in the construction sector, in both housing and other constructions. The necessary adjustment in this sector, after the real state boom that occurred in various member states, is not over, as shown by a new fall in the construction production index in October-November of more than 1.0% q/q, and everything suggests that construction will continue to be a drag on investment in coming quarters. On top of that, gross fixed capital formation could have been negatively affected by credit restrictions on businesses, as loans fell by 1.5% in 2010, after the already strong moderation observed in 2009. Finally, positive signs came from the rapid increase in capacity utilization in the second half of 2010, which is now close to its historical average and suggests that investment should grow further in coming months (Chart 10).

Chart 9
Eurozone: Industrial production and investment (% y/y)



Source: Eurostat

Chart 10
Eurozone: Capacity utilization (%)



Source: European Commission

In 2010 as a whole, investment will end up contracting slightly in the eurozone, but much less than in 2009. Countries without large imbalances in their construction sector have experienced significant boosts, such as Germany, whose investment was also fostered by strong external demand of capital goods from emerging economies, particularly from Asia.

Strong moderation in public consumption due to fiscal retrenchment in non-core countries

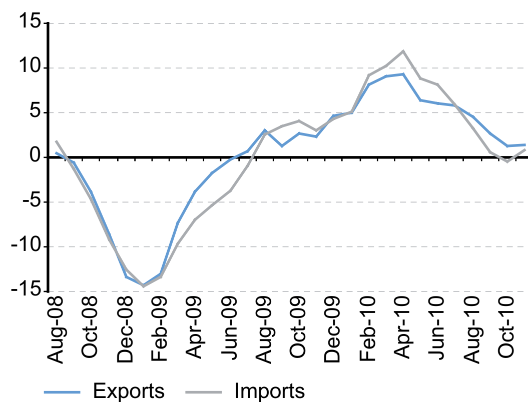
Public consumption growth in the eurozone as a whole moderated substantially at the end of 2009, as strong fiscal adjustment measures were put into place, particularly in some periphery countries, after a considerable increase of the structural deficit and stimulus plans implemented during the crisis. Core countries, whose deficits were affected by the recession to a lesser extent, continued in fact with their stimulus programs. Overall, public consumption probably closed around 0.7% in 2010, after growing at rates over 2% in the period 2006-2009. As a result, public deficit in the eurozone remained broadly stable, declining only slightly by 0.1pp to 6.2% of GDP. At the national level, the deficit remained broadly stable in countries with lesser problems in their public accounts and only declined in those countries that had to appease financial markets.

Net foreign demand contributed positively to growth in the second half of the year, despite the deceleration of exports growth

Exports growth in the eurozone decelerated significantly in the third quarter of last year, as a consequence of a moderation in the global demand recovery. Nevertheless, net exports contributed positively to quarterly growth for the first time in the that quarter due to a greater decline in imports than in exports growth, possibly as a response to smaller intermediate goods needs to satisfy orders and to the end of the restocking process. Data available at the end of 2010 also show that the recovery of the global economy continues at a firm pace, especially in emerging economies, to which over 20% of eurozone exports are headed. Trade balance data up to November also confirm that the deceleration of exports could have been interrupted in the fourth quarter, even growing at a faster pace than imports (Chart 11). This suggests net exports should end up contributing positively to economic growth at a similar magnitude than the one registered in the third quarter. In short, both exports and imports will register high growth rates (close to 10%) at the end of 2010, very close to pre-crisis levels.

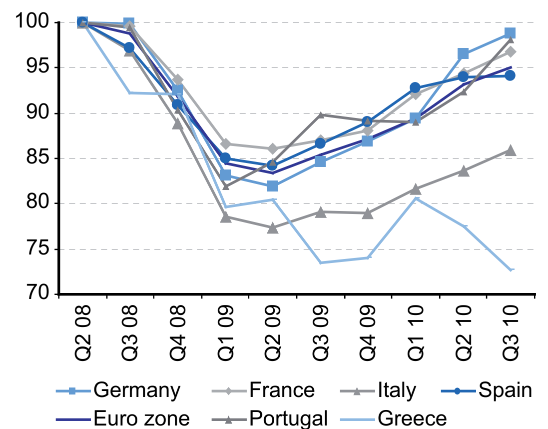
Across member states, Germany benefited the most from the global recovery with exports growth rates close to 5 pp over the eurozone average, while the impact was much more moderate in the rest of the area (Chart 12).

Chart 11
Eurozone: External trade (3-months moving average)



Source: Eurostat

Chart 12
Exports by country (Index, T=100, T=2008Q2)



Source: Eurostat and BBVA Research

Overall, the performance of the eurozone economy in 2010 has been better than expected, despite the uncertainties that still surround it

Based on our previous analysis, the eurozone would have grown around +1.7% in 2010, broadly in line with our previous forecast (1.6%) of November Europe Economic Outlook. While we wait for the release of final data, our forecasts suggest that this increase would have been based on moderate consumption growth, in both private and public sectors, along with the strong contribution of inventory restocking. Gross fixed capital formation contracted at a marginal pace if compared to falls in previous crises, and mostly as a consequence of strong falls in construction investment. Finally, and despite the extraordinary recovery of exports, the contribution of net exports has been flat, due to an also strong rise of imports.

Despite the relatively good evolution of macroeconomic data, there are still serious issues to be addressed in the eurozone before we can see sustained growth. One is the establishment of a permanent crisis resolution mechanism that could help solve the sovereign debt crisis. This is dicussed in section 3.3. One other element is clarifying the future of the financial sector, allowing it to return to optimum performance

The stabilization of the labour market has consolidated at the end of 2010, but without job creation

The eurozone unemployment rate remained relatively stable in 2010, increasing by 0.1pp in the second quarter and stabilizing at around 10% in the second half of the year, in line with our forecasts. Confidence surveys, however, showed more positive signs in the last few months of the year, indicating an expansion in business hiring intentions. This was particularly evident in the industrial sector, driven by a renovated push from export orders. Although the general assessment of available data suggests that unemployment should have reached its cyclical peak in the last quarter of the year, we do not expect a sustained unemployment reduction in the short run.

The strong and heterogeneous deterioration of the labour market in the different economies of the eurozone underscored the significant structural differences among them, not only in the performance of their labour market, but also in their underlying economic imbalances. In spite of this, the stabilization of the labour market in the second half of the year was widespread, although Germany continued to perform much better than the rest, with a reduction of almost one percentage point in the unemployment rate by the end of 2010, as compared to the previous year, highlighting the success of its short-term schemes. German employment stagnated at the beginning of the recession up until the first quarter of 2010, and started generating jobs as from the second quarter, with an increase of about +0.5% for 2010. In contrast, employment in the rest of the eurozone was around -0.5% in 2010 as a whole.

Inflation picked up in the second half of the year due to the increase of commodity prices, without signs of second round effects

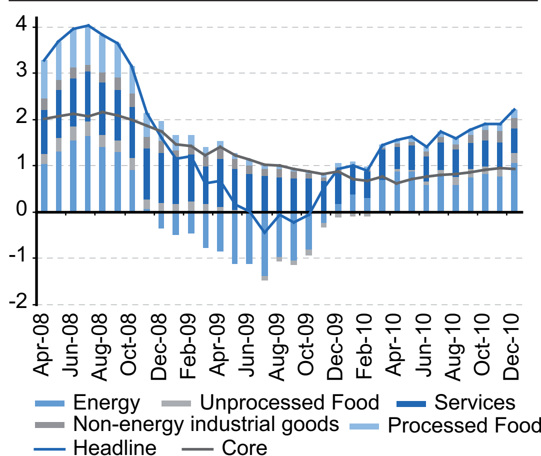
Inflation continued to increase in the second half of 2010, in line with our projections. As in the first semester, this was fundamentally caused by continued price increases in energy, after the intense fall recorded a year earlier. However, in contrast to the previous half of the year, the increase in the energy component in the second half corresponded mostly to a more depreciated euro, although the price of the barrel of Brent also picked up strongly in December. With these drivers, inflation in energy goods moderated slightly in the third quarter of 2010 and accelerated significantly in the last quarter, with December reaching a +11% y/y rate. Apart from energy prices, the increase of inflation was also fueled by higher food prices in the second half of the year, especially in non-processed food, due to the adverse effect of bad weather conditions.

In short, energy and food components were responsible for approximately 90% of the rise of inflation (Chart 13). The rest of the increase was due to a moderate rise in service and non-energy industrial goods prices that responded mainly to consumption tax increases. Hence, core inflation was stable at +1.0% y/y in the third quarter, with a minimal acceleration to +1.1% y/y by the end of the year.

These trends resulted in higher inflation in those countries with higher energy dependence, as well as in those with indirect tax hikes as part of their fiscal consolidation schemes.

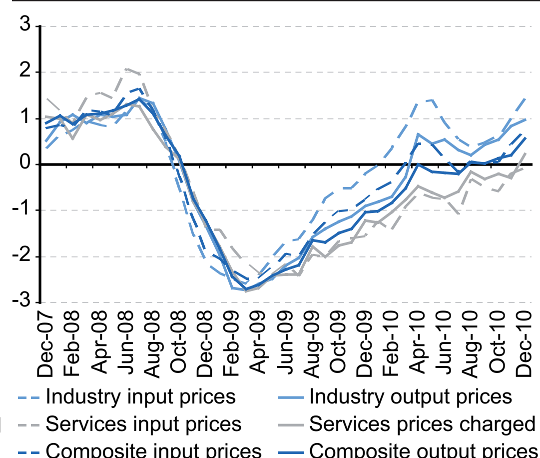
The inflation rate reached 2.4% in January 2011. It is expected that it will continue above 2% due to the energy component for a few months, while the new question is whether or not second round effects will arise. Signals from business confidence surveys (Chart 14) in the industrial sector suggest that firms are willing to raise prices further. In the service sector, however, evidence of this type of behavior is much more moderated as a consequence of a still weak domestic demand. Apart from these survey responses, it is still to be seen if in practice firms are able to raise prices and nominal wages are affected by higher energy inflation. The evidence we have on this is that second round effects are not likely to be large (Box 2).

Chart 13
Eurozone: HICP inflation



Source: Eurostat and BBVA Research

Chart 14
Eurozone: Firms' expectations on prices



Source: Markit Economics

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

For 2011 and 2012, our projections of GDP growth for the eurozone have been revised significantly upwards, by 0.5pp and 0.4pp respectively, to 1.7% and 1.8%. The key drivers underlying these revisions are: i) the base effect resulting from a stronger economic momentum in Q2 2010 (+0.2pp in 2011), ii) an euro exchange rate more depreciated that in the previous scenario (+0.3pp in 2011 and +0.2pp in 2012) coupled with a more resilient global economy than initially expected, and iii) a stronger performance in core countries (+0.2pp in 2012) (Chart 15).

For 2011, we still see exports as the key driver of economic recovery in the eurozone as a whole, as global demand regains momentum, thus offsetting the sluggishness of domestic demand. In addition, we think that the strong recovery of industrial sector is not clearly pulling other economic sectors. Hence, we remain cautious regarding the possible acceleration of economic growth due to the modest weight of industrial sector (around 20% of total Gross Value Added) in total economy. Nevertheless,

across member states the picture could be different, as recent data suggest that private demand could be picking up in core countries, especially in Germany, while domestic demand continues to act as a drag on growth in the periphery due to fiscal retrenchment, private sector de-leveraging, tight credit conditions, and a weak labour market. As adjustments are already in progress and conditions in both the labour and the financial sectors are expected to improve for next year, domestic demand should be taking the lead in driving economic growth in 2012.

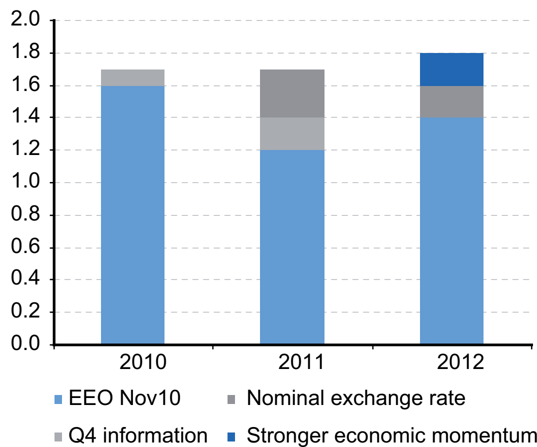
Our forecasts envisage the following pattern of GDP components on the demand side:

- We expect a modest growth of private consumption, as drivers will remain subdued over 2011. Specifically, households' disposable income will grow only slightly, as wages should increase moderately and in line with inflation forecasts due to a still very negative unemployment gap. Nevertheless, the ongoing improvement in loans to households should continue in the forecast horizon, as households' leverage was not too high at the eurozone level and precautionary savings faded, boosted by still low interest rates. On average, consumption is expected to increase by 1% in 2011, accelerating to 1.5% in 2012.
- Investment is expected to increase in coming quarters, especially capital investment, as observed over 2010, supported by stronger export orders and the fact that capacity utilization is already close to its long-run average. Nevertheless, we see a mild investment growth in both 2011 and 2012 since uncertainty surrounding the economic outlook will remain high, while credit conditions, especially to firms, could still be tight. Adjustments in the construction sector should continue to proceed over forecast horizon.
- Member states will have to implement austerity measures in both 2011 and 2012 in order to meet the Stability and Growth Pact targets as soon as possible, causing public spending to slow again in 2011 and to remain weak in 2012.
- As a result, after the strong contribution to GDP growth in 2010, domestic demand is expected to slow in both 2011 (1.1pp) and 2012 (1.4pp).
- This should be offset by a higher contribution of net exports, especially in 2011 (0.6pp), as exports will continue to grow at robust rates (although not as high as in 2010) supported by the regaining momentum in global demand, while the slowing of imports should be more intense as a result of weak domestic demand.

On consumer prices, we think that the recent upward trend should be temporary as headline inflation is expected to reach a local maximum around 2.3% y/y in Q1. Afterwards, it is expected to moderate driven by lower energy inflation (a downward base effect after the strong increase registered in 2010) and by the sluggishness of domestic demand, remaining close but below the ECB's target at the end of the year. Specifically, our models estimate that the probability of headline inflation remaining clearly above 2% after Q2 2011 would be around 40% (Chart 16). Core inflation should increase moderately in early 2011, remaining thereafter relatively stable for the remainder of the year. As a result, we project inflation for 2011 to be at 1.8% (headline) and at 1.4% (core). For 2012, headline inflation is expected to moderate slightly further, while core inflation should remain relatively stable.

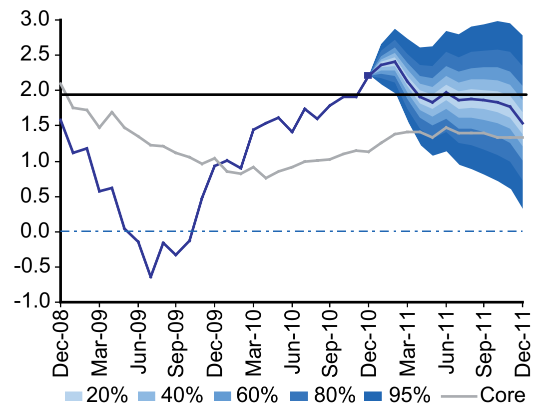
Regarding the labour market, employment is expected to increase timidly in 2011, around 0.5%, as firms are likely to remain cautious on hiring intentions until concerns about the sustainability of the recovery would are dispelled, accelerating somewhat over 2012. As a result, the unemployment rate could have peaked at the end of 2010, but it will probably take a while before it falls clearly. It is expected to remain close to 10%, with a slow declining pace both in 2011 and 2012.

Chart 15
Eurozone: GDP growth (annual average growth, %)



Source: Eurostat and BBVA Research

Chart 16
Eurozone: HICP inflation (% y/y)



Source: Eurostat and BBVA Research

Risks to economic growth are tilted on the downside, while inflation risks are on the upside

On activity, we continue to stress on some downside risks coming from i) liquidity tensions that are not yet solved, ii) a possible contagion to a large country, while iii) a satisfactory solution on governance issues in Europe has to be clearly defined. European institutions continue to work on the latter issue, and indeed the recent improvement in the performance of sovereign debt markets is the result of such work. In addition, contagion from financial woes to real activity, especially in core countries, has been very limited so far, so the gathering pace in domestic demand could continue and, therefore, economic growth could be higher than projected here in core Europe in 2011.

Regarding the inflation outlook, we think the upside risks could come from potentially higher commodity prices and further euro depreciation (if sovereign problems persist in coming months), as well as possible additional tax hikes required to strengthen public finances. Nonetheless, the latter should be virtually offset by the still negative output gap along with a hypothetical worsening of consumers' confidence.

Box 2: Assessing the risks of the persistence of current high oil prices on inflation

Oil prices play an important role in price performance, as oil is used as a final consumption good as well as input factor in the production process. There is a direct effect of oil prices on consumer prices through energy items in the households basket, while indirect effects surge when firms end up passing higher input costs on to consumer prices in order to maintain their profit margins. In addition, sizeable oil price shocks could also result in higher wages triggered by the increase in inflation expectations, and thus affect inflation through second round effects. It is also worth noting that the direct effect of a permanent oil price increase has a lasting impact on the level of consumer prices, while the impact on the inflation rate is relatively short-lived. In contrast, the impact of both indirect and second round effects on inflation is more persistent due to its slower and more gradual transmission, along with downward rigidities in wages.

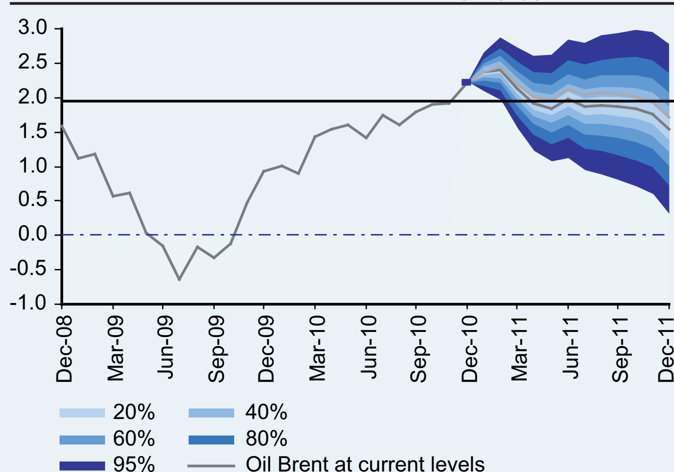
The increase in headline inflation observed in 2010 to 1.6% (from 0.3% in 2009) was mainly explained by the direct effect of changes in oil prices (an annual increase of around 30%) on energy inflation, combined with a similar effect, albeit in the opposite direction, over 2009. Given the sluggishness of domestic demand and the deterioration in the labour market, neither indirect nor second round effects took place, as shown by lower annual inflation in both services and non-energy industrial, as well as the moderation observed in nominal wages.

Here we assess the potential risks on our inflation forecasts if oil prices remain at current high levels over 2011, instead to reverting to $88 per barrel at the end of the year as in our baseline scenario. In particular, a price of Brent remaining at around $100 per barrel means a further increase of around 15% compared with our baseline scenario. We estimate the direct effect on inflation at around 0.2pp on the average annual headline inflation in 2011 (Chart 17). In that case, annual inflation would remain slightly above the ECB's target until the third quarter of the year, showing the short-lived effect of the direct impact. Nevertheless, the nominal exchange rate of the euro is also likely to remain more appreciated than in our baseline scenario in case of persistent high oil prices, thus cushioning somewhat the direct effect.

In order to calculate the impact on inflation owing to both indirect and second round effects, we have estimated a VAR model to analyze the dynamic interaction between gross domestic product, core inflation (to discount the direct effect), oil Brent prices and nominal exchange rate. We estimate the model by Bayesian methods (under usual assumptions) and compute impulse response functions, after arranging variables according to an exogeinity pattern. The impulse response function of core inflation to an oil price increase of 15% with respect to our baseline scenario (consistent with oil prices at $100) shows (Chart 18) an impact of somewhat less than 0.1pp over the first year, lingering over the next one and dampening afterwards. We have also considered including interest rates in the model in order to incorporate the monetary policy reaction, but the results barely change, as its effect should be covered by former variables in the previous reduced model.

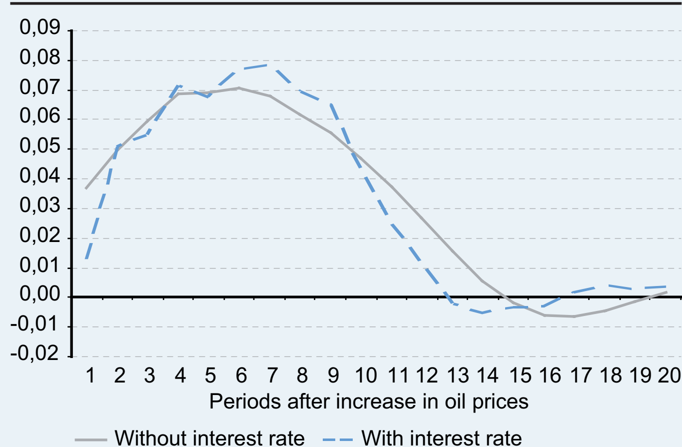
Taking into account all effects, the total impact of 15% oil price increase on annual average headline inflation could be around 0.3pp in 2011. In addition, indirect effects are unlikely over this year as the still subdued domestic demand should put a break to the pass-through channel of cost increased on to subsequent price stages. In sum, as inflation expectations seem to remain well anchored (Chart 19), we do not see second round effects as a concern in the short-run. Overall, as those latter effects seem to be limited, we do not see particular inflationary pressures in coming months that cut push the ECB to hike interest rate. A different matter is that the ECB maintains a hawkish tone regarding oil prices, precisely because it wants to avoid increasing price expectations.

Chart 17
Eurozone: direct effect on inflation (% y/y)



Source: Eurostat and BBVA Research

Chart 18
Eurozone: indirect and second round effects



Source: BBVA Research

Box 2: Assessing the risks of the persistence of current high oil prices on inflation (Cont.)

These VAR model results are in line with existing empirical evidence in the literature[1] from large-scale macroeconomic models (Chart 20). For the purpose of contrasting results, we estimate the impact of a permanent increase of 50% in the level of oil prices on eurozone inflation. Empirical evidence suggests that this rise in oil prices adds 0.3 to 0.6 percentage points to overall inflation within the first year, reflecting, to a large extent, direct effects. Our estimation is of a direct effect of around 0.4pp, while both indirect effects and second round effects should add a further 0.2pp. For the second year, since direct effects on inflation are only temporary, our estimation points to an impact of around 0.2pp, diminishing to 0.1pp in the third year. This compares with effects between 0.1pp and 0.4pp in the second year and between 0.0pp and 0.1pp in the third year in other models.

Chart 19
Euro inflation-linked swap breakevens

Source: Bloomberg and BBVA Research

Chart 20
Impact of a 50% increase in oil prices on eurozone inflation (percentage points)

	Year 1	Year 2	Year 3
ECB AWM	0.5	0.4	0.1
EC QUEST	0.4	0.1	0.1
NiGEM	0.3	0.2	0.0
OECD interlink	0.6	0.2	0.1
BBVA	0.6	0.2	0.1

Source: ECB and BBVA Research

1: *See Oil prices and the euro area Economy* in ECB Monthly Bulletin, November 2004

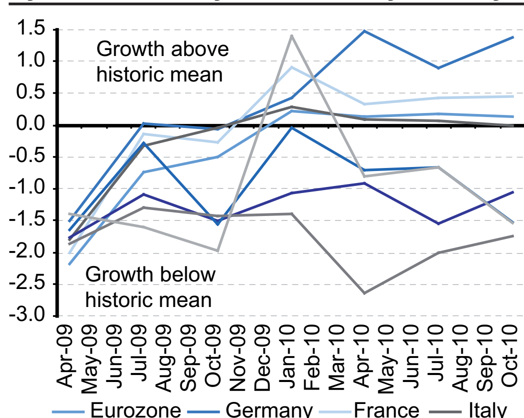
2.2. Member states: A closer view

Two-speed recovery

As already shown in the previous section, the differences between core and periphery countries in the eurozone have widened once again in the last quarter of the year. Divergence increased as a consequence of greater financial tensions in the periphery, the correction of economic imbalances, and fundamentally different fiscal adjustment processes. As exports to emerging economies remain the key driver of the current recovery, Germany, more specialized in the kind of goods demanded by these countries, is also growing more rapidly than the rest of the eurozone.

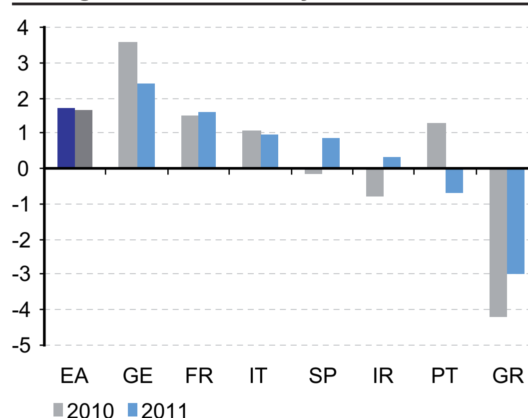
Our synthetic activity indicator by countries (Chart 21) corroborates increasing disparities in the rates of the recovery. These synthetic indicators are elaborated from standardized national short run indicators, covering the main production sectors, weighted according to its correlation with output[2].

Chart 21
Synthetic activity indicators by country



Source: BBVA Research

Chart 22
GDP growth forecast by countries



Source: Eurostat and BBVA Research

Germany: Stronger growth than expected; leading the eurozone recovery

Clearly, the economic recovery in Germany has been stronger than expected, mainly due to strong external demand from emerging economies, especially from Asia, and particularly in investment goods, contributing significantly to growth in the year as a whole. Hence, the economy closed 2010 with a growth rate of +3.5%. Nonetheless, there has not been a clear translation yet from external demand to household consumption, in spite of the reduction in the unemployment rate and significant increases in consumer confidence. Retail sales, particularly, remained stagnated and household consumption figures from national accounts do not clearly confirm a strong pick-up of internal demand that can make the recovery self-sustainable.

Our forecasts for 2011, although more moderate than those that took pace in 2010, do consider a more balanced growth path, sustained by greater employment and reinforced investment demand. The latter is likely to come about from the need to expand, once capacity utilization has reached high enough levels, as we expect external demand to continue firmly during 2011. In short, we expect a contribution from domestic demand somewhat lower than the one observed last year, held back by a significant reduction of public consumption and lesser contributions from changes in inventories after the restocking process is complete. Furthermore, we do not expect these to be offset by private consumption or investment strength, which will be moderate. Regarding the external sector, after the extraordinary growth that exports recorded in 2010, we expect them to decelerate considerably; and, although imports deceleration will be stronger, the net exports contribution is also expected to decline. The main downside risks pressing on this economy are primarily the uncertainty surrounding the eurozone as a whole, and the impact of an unresolved financial crisis over the German banking sector.

Regarding the evolution of prices, inflation also accelerated significantly in the second half of 2010, from a rate close to 1% in the second quarter of the year up to 1.9% observed in December, mainly driven by the evolution of energy prices. Core inflation increased moderately, by around 0.1pp in the same period. In 2010 as a whole, both headline and core inflation stood below the eurozone aggregate. For

2: Being standardized around their mean, these indices actually show if those economies have been growing above or below their historic average growth, and do not reflect directly differences in current growth rates

2011, we expect these differences to diminish. Robust growth and good labour market performance could result in somewhat higher nominal wage increases, as well as a moderate acceleration in domestic demand that could result in greater second round effects, although we do not expect these to be large. Henceforth, our inflation forecast for 2011 as a whole is set at +1.8% y/y, like in the eurozone, with a slightly declining tendency, and keeping relatively stable throughout 2012.

On the fiscal front, the reduction of the deficit ratio to 3.5% of GDP in 2010 goes in line with the good performance of economic activity. The German deficit closes 2010 much below the Stability Programme target at 5.5% of GDP. It is very likely that Germany will reach in 2011 a deficit of around 2.5% of GDP, below the Maastricht benchmark, accelerating the consolidation process with respect to plans. In spite of the good performance in its deficit, the Maastricht debt will increase to 75.5% of GDP in 2010 due to the inclusion of the Landesbanken rescue package.

France: Moderate and balanced growth

While Germany's economic growth pulled through the exports sector other economies from Northern and Central Europe, the French economy's performance was positive but not as bright. France resisted better than Germany during the recession thanks to the resilience of its private consumption. Throughout 2010, it recovered in a balanced way with moderate consumption growth, both in the public and private sectors. Meanwhile, the strong exports growth did not avoid a fall in investments, although it lessened the decline. In any case, domestic demand contributed positively to growth. As a consequence of the resilience shown by the internal demand, the economy sustained a dynamic imports sector, resulting in a weak contribution by the external sector. In short, growth in the French economy has been clearly below Germany's, with a forecasted average annual growth at around 1.5% in 2010, slightly below the eurozone average. Nevertheless, this modest activity recovery has not been felt clearly in jobs creation, and thus the unemployment rate stood at 9.7% at the end of 2010, two tenths below the rate recorded at the beginning of the year.

Our growth forecasts suggest that this growth pattern will continue throughout the forecast horizon. Domestic demand will increase its contribution to growth, sustained by the resilience of private consumption and higher investment levels, while it will be held back somewhat by the end of fiscal stimulus and austerity measures. Regarding the external sector, we expect that both exports and imports decelerate this year, after the strong growth recorded in 2010, and then remain stable in 2011 and 2012, with flat contributions to economic growth in both years. Taking this growth path into account, we expect a slow improvement in the labour market, with unemployment rates above 9% throughout the forecast period.

Due to the dynamism of private consumption, consumer prices increased rapidly at the end of 2009 and in the first quarter of 2010. As a result, inflation remained above the eurozone average during the first semester of last year. Nevertheless, all through the second semester inflation was fairly stable, and thus average annual inflation was just above the eurozone average, at 1.7%, while core inflation was reduced by 0.4pp compared to 2009, down to 0.9%. Our forecasts suggest inflation will remain relatively stable in 2011 and 2012.

The French State deficit was €-148.8 bn (-7.6% over GDP) at the end of 2010, in line with the target set in the last supplementary budget from December at €-149.8 bn. The General Government target was set at 7.7% of GDP, a figure that was revised downwards from an initial 8.8% presented in the SGP at the beginning of 2010, it is likely to be met. For 2011 the general government deficit is expected to be reduced mildly to a -6% of GDP, in line with the government target of -3% by 2013. Debt will reach a 83.2% next year and will continue and upward up to 2014, when it will start reverting at a slow pace.

Italy: Clearly behind largest countries

As in previous cycles, Italy is recovering with some lag with respect to France and Germany. Exports have grown more slowly than in Germany and the fiscal stimulus has been weaker due to narrower fiscal margin. Specifically, public consumption is expected to have contracted in 2010 as a whole. Such weaker anti-cyclical fiscal measures were also evident in the strong fall of consumption over the recession, as well as in its sluggish recovery in 2010.

In short, the main driver of economic growth has been foreign demand that ended up boosting investment. We expect investment to have grown in 2010, after two years of consecutive falls, particularly suffering from a strong decline in 2009. Recent short-term data available for the fourth quarter suggest that economic growth could have slowed further in the last quarter of last year, leaving the Italian economy clearly behind the rest of the largest countries, with growth at around 1.0% in 2010 as a whole. The deterioration of the labour market has been moderate though, with the unemployment rate at around 8.6% by the end of the year, only two tenths above the rate recorded in 2009.

The sluggishness of households' spending is projected to remain in the next two years, as the labour market conditions will barely improve. In addition, the Italian economy, in contrast to the German one, will benefit to a much lesser extent of enhanced global demand, resulting in a lower investment growth as well as timid net exports contribution. Overall, we see Italian economy growing at a slow pace over the forecast horizon.

Regarding price developments, Italian inflation also accelerated in the second half of 2010, as the result of accelerating energy goods prices, while core inflation remained relatively stable, but at higher rates than eurozone average. For the next two years, given the weakness of private consumption, we expect inflation to remain relatively stable and below 2%, with upside risks only coming from a shock in import prices.

On public accounts, the Italian government projected a -5% deficit in 2010 and plans to reduce it to -3.9% in 2011 and -2.7% in 2012. Austerity measures are designed to save around €24 bn (1.5% over GDP), equally distributed across two fiscal years 2011 and 2012. Budget execution up to Q3 remained broadly on track to attain the target for 2010. Consolidation plans for these two years are relatively less ambitious compared to its peers, in part because the initial deficit was relatively low, and risks of slippages are very small even under the assumption of increasing spreads. Public debt is expected to remain hovering at around 119% of GDP.

Spain: Ongoing economic adjustments, with a slow recovery during the second half of the year

The Spanish GDP has fallen slightly in 2010 as a whole, showing a pattern of growth characterized by a sluggish domestic demand and strong net exports, respectively affected by fiscal policy changes as well as the good performance of export drivers.

The Spanish Government launched an ambitious fiscal consolidation process in 2010, after an extensive and effective fiscal stimulus over the crisis. As a result of increasing international financial strains over the spring, fiscal retrenchment was reinforced in the second half of the year by introducing new discretionary measures and adopting a schedule of structural reforms. Data on the Central government deficit point towards an undershooting of its fiscal target, showing enough room to ensure the achievement of the overall target (-9.3% over GDP) for the general government. This fiscal retrenchment had a significant impact on the performance of domestic demand in 2010: directly, through the gradual adjustment in public consumption and investment and indirectly, through its effects on consumption and investment decisions made by private sector.

On the external front, exports keep showing positive growth and showing themselves as the key driver of economic recovery owing to resilient global demand along with the diversification of exports by country and gains in competitiveness.

After the VAT hike by mid-year, with a moderate pass-through to final prices, inflation accelerated at the end of 2010 driven also by higher oil prices. In particular, inflation increased to 3% y/y in December, with annual average headline inflation at 1.8% in 2010 as a whole. In contrast, core inflation increased only moderately, remaining at 1.5% at the end of the year. Overall, there was no evidence of second round effects, although inflationary pressures from high energy prices.

In the forecast horizon we do not expect abrupt changes regarding the sources of domestic growth. Given the ongoing fiscal consolidation, public demand will continue to drag down activity in both 2011 and 2012. The pace of recovery in private domestic demand will be adversely affected by subdued fundamentals and the ongoing correction of some private sector's imbalances (de-leveraging and real estate sector adjustment). In addition, renewed financial strains could be a further downward risk on activity, given the dependence of the Spanish economy on foreign financing. Regarding the external sector, exports momentum is likely to gather some additional strenght, driven by improved growth expectations in Europe, a slightly weaker euro than expected three months ago, geographic diversification and ongoing gains in competitiveness. Overall, we see a still weak recovery pace in coming quarters, with annual economic growth at around 0.9% in 2011 as a whole. Nonetheless, economic growth over the second half of the year could be strong enough to show net job gains for the first time since the beginning of the crisis, with enhanced employment over 2012 as annual economic growth is expected to be around 2%.

Box 3: Portugal: Fiscal consolidation and household deleveraging shape the outlook

In spite of fears of contagion Portugal has avoided asking for help from the European intervention fund. In recent auctions at the beginning of 2011, Portugal has managed to cover funding needs at lower interest rates than previous auctions held at the end of last year and demand was oversubscribed. However, in spite of the relative positive balance for 2010 in terms of activity, it will face many challenges in the current year: The size of fiscal adjustment is large as the deficit is expected to fall from -7% in 2010 to -4.6% in 2011. Indeed, the consolidation measures needed to achieve such target are behind the expected double-dip in activity. Portugal also needs to restore confidence so as to reduce financing costs further. In the medium term, the long-standing need to promote growth and competitiveness is even more necessary. If other periphery countries have suffered from bubbles in the construction sector or problems in their financial system, the main problem of Portugal is the lack of substantial growth potential and a current account balance that does not adjust quickly. This requires the implementation of structural reforms without delay.

Recent economic developments

Portugal is expected to have closed 2010 with a real average growth rate of 1.4%, above expectations as Q4 declined moderately. Private consumption recovered rapidly while gross fixed capital formation slowed its pace of decline from -11.6% to -4.5%. The external sector contributed positively to growth as exports accelerated to 8.9% and imports, in line with weak domestic demand, grew by much less (4.7%). Recent leading indicators show that consumer confidence remains at very low levels as the unemployment rate increased to 10.9% in Q3, 1.1pp higher than a year early. The deterioration of labour market continued despite the relatively good performance of economic activity in recent quarters, where industrial production and exports are performing quite well.

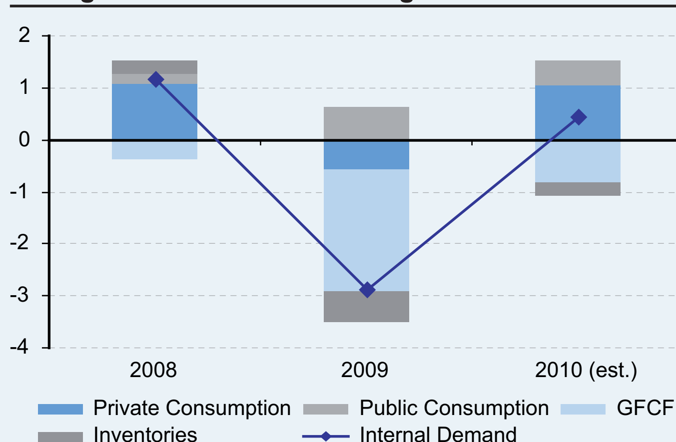
VAT increases and energy prices pushed prices

The annual average rate of inflation for 2010 was 1.4%, after falling by -0.9% in 2009. Inflation accelerated in the second half of the year after the VAT increase that took place in July 2010 (by 1.0 pp to 21%), remaining relatively stable in the end of Q3, but accelerating again at the end of the year boosted by higher energy prices. The additional increase of the VAT in 2 pp from January onwards will have an additional impact on consumer prices and we expect inflation to average 2.6% in 2011.

Downturn in 2011

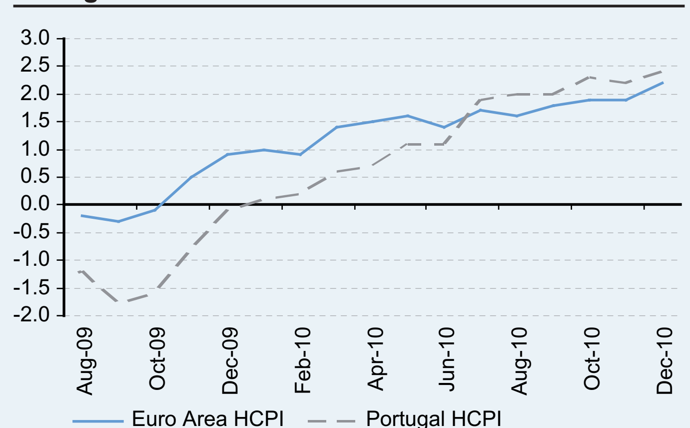
Economic growth is expected to be –0.5% in 2011 due to the magnitude of the fiscal consolidation effort. This will impact all components of domestic demand, but we expect a strong contribution from the external sector. Private consumption is expected to decline by about –1.4%. This is explained by the effects of fiscal consolidation package on household disposable income, as the decline in public sector wages is expected to have spillover effect on the private sector and taxation will also affect consumption. In addition, indirect tax hikes could have been reflected in frontloading durable goods purchases, implying a fall in coming quarters, while credit constraints are also likely to play a role in restraining consumption. Public consumption and investment are likely to fall by more than -4%. All in all, the contribution of domestic demand to GDP growth could be of about -3 percent points. Prospects on the external sector are more positive as imports, in line with weak domestic demand, are expected to fall, allowing the relative good performance of exports to contribute positively to growth by a large margin (about 2.5 percentage points of GDP in 2011).

Chart 23
Portugal: Contribution to GDP growth



Source: INE and BBVA Research

Chart 24
Portugal: CPI



Source: Eurostat and BBVA Research

Box 3: Portugal: Fiscal consolidation and household deleveraging shape the outlook (Cont.)

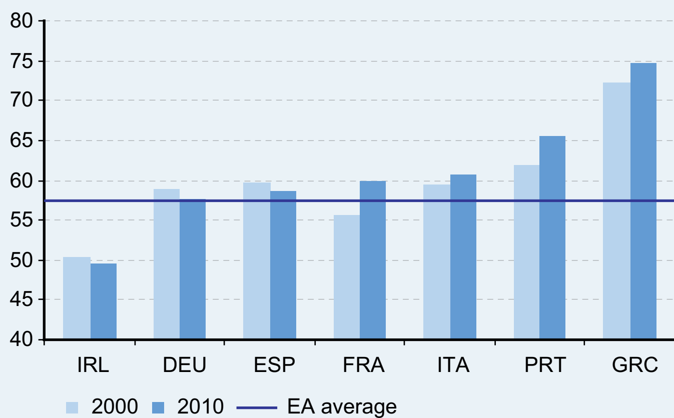
There are downward risks. First, the reliance on the external sector will be conditional to the global economic developments and the euro area. Second, financial tensions can re-emerge if budget deficits are not met and the recent reform spirit vanishes. And third, the impact of the fiscal consolidation turns out to impact more adversely on the private sector.

The **medium-term challenge**: The need to enhance the reform process to correct imbalances and promote growth

From a structural point of view, Portugal has two key problems: a persistent and high current account deficit and low economic growth potential. Both are interrelated and derive from a low level of productivity growth. The high current account deficit reflects also its high dependency on energy as well as high private consumption ratio (Chart 25 and 26).

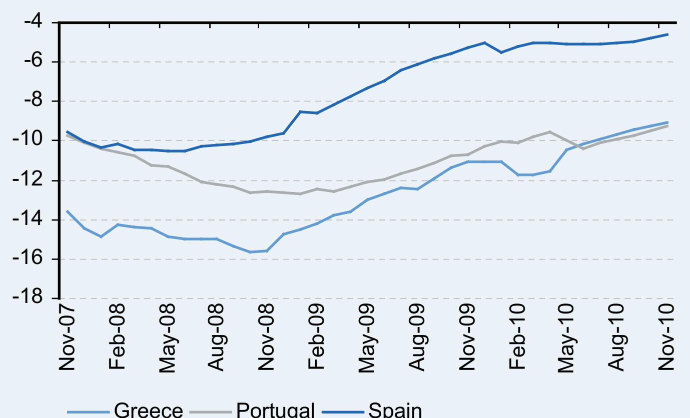
Structural reforms would help to increase productivity, boost potential growth and solve competitiveness problems. Reforms should bring into focus on human capital, innovation and labour market. The Portuguese government announced at the end of 2010 several actions focusing on economic competitiveness, export promotion and innovation. But the most relevant in our view is the labour market reform, which intends to promote the decentralization of collective bargaining and reduce dismissal compensation. These measures are still to be defined, though.

Chart 25
Consumption ratios as % of GDP



Source: National sources and BBVA Research

Chart 26
Current account deificit (% PIB)



Source: National sources and BBVA Research

3. Crisis in the periphery

Despite swinging movements, financial tensions in the periphery of the eurozone have eased recently. Two factors are important here: Individual countries embarked in further fiscal consolidation and some structural reforms, and European leaders provided signs that they will provide the adequate financial and institutional framework to tackle the crisis. In the first sub-section we look at the market evolution over recent months, while the second looks at measures taken by different countries and the third provides our view on the best framework for European governance that should be approved at the end of March summit of the European Council.

3.1. Market developments: Softened tensions

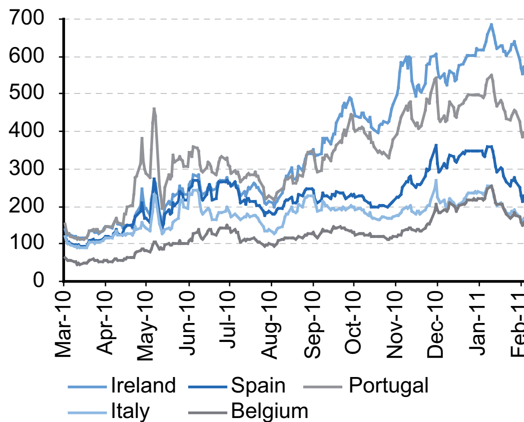
During 2010 financial markets have been marked by two new episodes of sovereign crisis (chart 27). In October there was an increase in risk premia due to banking problems in Ireland, which finally ended on November 21 with the request by the Irish state for assistance from European authorities, making Ireland the second country in the Euro zone to be rescued. The Irish rescue barely helped to contain the risk premia and, in any case, only in a temporarily. The underlying elements of the sovereign debt crisis, i.e. the lack of consensus in the European Union to resolve liquidity and solvency problems that threatened a growing number of countries, together with structural weaknesses in some peripheral economies, remained latent. Hence, at the beginning of 2011 financial markets entered another increase in risk premia primarily on fears that Portugal would become the third country in the euro zone to ask for help. This time countries labeled as core countries, such as Belgium and Italy, were significantly affected.

In this context, some elements have helped to soften financial tensions throughout the month of January. At the European level, governments have shown a sense of urgency to solve financial tensions that has led to greater consensus on the establishment of a governance framework to deal with the current and future crisis. This is expected to be solved at the EU Council Meeting in March, and the news that things are moving in this direction have helped to lift markets. With respect to peripheral countries, these have accelerated the pace of reforms, especially Spain, and furthermore they have received European support. These developments have given way to moderate optimism, giving financial markets some relief, although the market will continue to be sensitive until these advances are consolidated, as there is a risk that future events may disappoint.

In our projections, we assume this improvement in the debt crisis will consolidate very gradually and will be materialized in two points: First, the issue of European governance will be favourably resolved; second, structural reforms and fiscal consolidation in peripheral countries move decisively in the right direction.

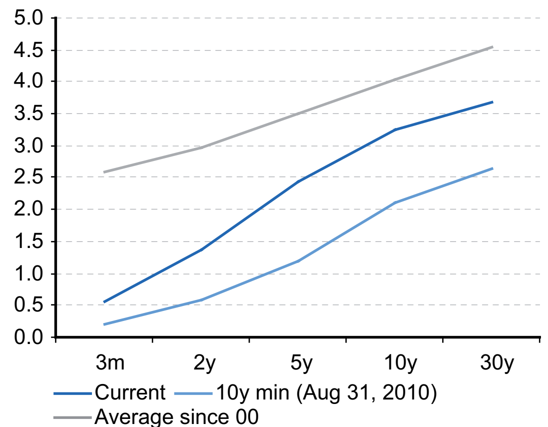
Meanwhile, interest rates have been increasing during the past few months as a result of an improving economic outlook, and of short-term upward pressures on inflation that have tilted risks to the upside. Initially, in November 2010 a sell-off in the long-end of the curve due to a rise in real rates –mainly determined by better-than-expected data– caused a steepening in the German yield curve (Chart 28). From early December up to date, 10-year nominal interest rates have increased further as a result of rising inflation expectations and a stabilization of real rates. At the same time, interest rates in the front end and the belly of the curve began to trend upwards, especially after the ECB adopted a more hawkish tone in early January. Nonetheless, the rise in this part of the curve is lower than the increase in long term-rates and thus, the yield curve is steeper.

Chart 27
Credit risk premium (5yr-CDS)



Source: Bloomberg and BBVA Research

Chart 28
German yield curve



Source: Bloomberg

3.2. Fiscal consolidation and structural reforms in the periphery move decisively in the right direction

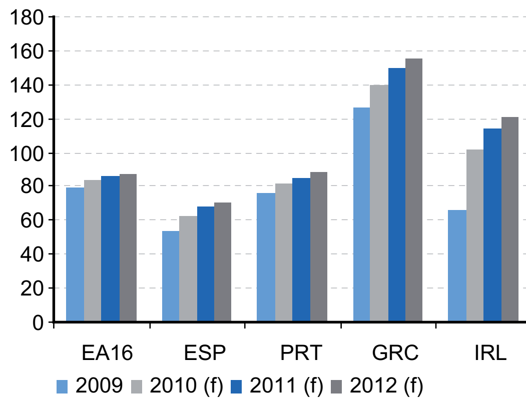
Fiscal targets for 2010 have been broadly met

Most periphery economies have carried out during 2010 an exercise of spending contention and pursued structural measures. This was not in the initial plans of many countries, as the economic downturn at the beginning of the year was still in place and there were doubts about the correct timing to withdraw fiscal stimulus and when to begin to consolidate. However, once the Greek crisis developed and started to affect other countries, these countries suffered market pressure and they were forced to accelerate consolidation plans and approve new measures.

Although data on general government deficit have not been yet published for 2010, figures from the Central government execution up to December suggest that targets will be met (Chart 29). This does not mean that deficit outcomes have been entirely satisfactory, as targets have changed in some countries during the year with respect to original ones (set out at the beginning of the year in their respective stability programmes). Greek Central government budget execution preliminary figures show a deficit of €-19bn (-11.3% of GDP), slightly below the targeted €20bn and a significant improvement on the €30bn recorded in 2009 (-13.2% of GDP). The Portuguese Central government balance closed in 2010 with a €-14.2 bn deficit, slightly above the €-14.1 bn registered in 2009; but thanks to the surplus of the Autonomous Fund, which includes the transfer of pension assets from Portugal Telecom (PT) of €1.8 bn, and to the social security surplus, the overall balance, without including regional and local administration figures stands at €-11.3 bn (-6.9% of GDP), broadly in line with the target of 7.1% of GDP. Without the transfer of PT pension fund, the final outcome would have been above target. In Ireland, the Exchequer balance up to December closed at €-18.7 bn (11.1% of GDP) compared to the €-24.6 bn in 2009 and to a target of 11.6% of GDP. These figures exclude the cost of support to the banking system (indeed, the nominal deficit figure will be around 32% of GDP). Spain will probably end up with a deficit of around 9% of GDP (below the objective of 9.3%) for the general government, thanks to the good implementation of the fiscal adjustment plan by the Central government and to a deficit for regional governments that should remain around the targeted 2.4% of GDP.

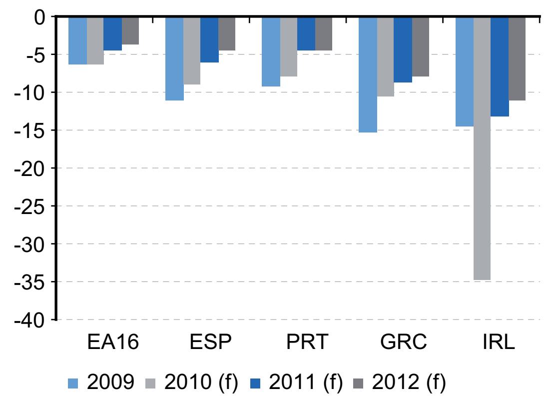
Given that 2010 fiscal balances seem to have been on track, the key challenges ahead are the consecution of 2011 targets (Chart 30), the possible impact on economic growth and whether if in spite of the deficit reduction, debt will be back to sustainable levels (Box 4).

Chart 29
General Government Debt (% of GDP)



Source: National sources and BBVA Research

Chart 30
General Government Deficit (% of GDP)



Source: National sources and BBVA Research

Consolidation plans are accompanied by structural reforms

Greece

Conditions to the €110 bn aid package to Greece announced last May included a sharp correction of central government accounts and important structural reforms. So far Greece has received €38 bn in 3 different tranches. The mission constituted by the IMF, the EU and the ECB, recently approved the release of the 4th tranche of the package (€15bn). Consolidation plans are expected to cut the budget by €30 billion over three years. Fiscal measures approved are varied: Public sector wages have been cut by up to 25 percent, and the fight against tax evasion and corruption within the tax service (a major issue in Greece) has been stepped up. VAT has been increased by four percentage points, together with a 10 per cent increase on fuel, alcohol and tobacco taxes and new property and gambling taxes. The average retirement age is set to rise from 61.4 to 63.5, and other measures have been approved that are expected to reduce pension expenditures in the future. Additionally, the Government aims to raise €7 bn over the next 3 years through privatizations.

The aid package is subject to strong conditionality also in terms of structural reforms. The government is already pushing forward on some of these, although progress in other areas is still lacking:

- The **pension reform** is quite advanced and near completion. The aim is to reduce the ratio of pension expenditure to GDP by 2060 to 2.5 points of GDP, instead of approximately 12.5 percentage points under the previous pension laws. According to a recent study by the National Actuarial Authority, in spite of the pension cuts and the lengthening of the retirement age, in order to achieve targets some additional measures might be required.
- The actions taken to **liberalize sectors** are underway, but achieving progress in 2011 remains key. The transport sector has been liberalized, legislation is in preparation to deregulate services and legislation on other reforms (diagnostic studies of the tourism and retail sectors) is being prepared. The liberalization of services includes professions such as lawyers, pharmacists, notaries, architects, engineers and accountants. Legislation is expected to be adopted by March 2011.
- On the **labour market**, the Government is preparing measures to reform collective bargaining, including the removal of the automatic extension of sector agreements for those workers not represented in the negotiations.

After the revision in October of past debt statistics, the debt to GDP ratio for 2009 was estimated at 127% (instead of the previous 115%). Under current plans, we estimate that Greek debt should reach 160% of GDP and then fall slowly. This is high and increases vulnerability to shocks.

Ireland

After months of stress following the recognition of problems in the banking sector, a rescue package of €85bn by the EFSF/IMF was announced in late November for Ireland under the form of an Extended Fund Facility (Footnote: An EFF differs from the Stand-By Arrangement with a longer repayment period, starting to pay back after 4 and a half years and ending after 10 years but holds strict conditionality in terms of structural reforms).

By mid-November the Government announced its National Recovery Plan, which was necessary to receive the rescue package, that encompasses the fiscal plan for the next 4 years with fiscal savings of €15 bn (9.5% of GDP) overall, of which €6bn (3.8% of GDP) will be achieved in 2011. The main austerity measures are the following:

- On the expenditure side, that accounts for €10bn: reduction of social welfare by €2.8 bn, cuts in the public sector wage bill by €1.2 bn by reducing the number of civil servants by 24,750, reductions in healthcare, education, agriculture and other government operations by €3 bn, cuts in capital expenditure by €3 bn.
- On the revenue side, that accounts for approximately €5 bn: higher personal income tax, a raise in VAT by 2pp up to 22% in 2013 and to 23% in 2014, and higher property tax and land tax. The corporate income tax remains unchanged at 12.5%.

Under this consolidation program, in our baseline scenario net lending in 2011 will still remain above 10% of GDP target as our growth assumption (0.3%) is less optimistic than the one by the Irish government (1%).As for public debt, the inclusion of the costs associated to the National Asset Management Agency (NAMA) in 2009 has risen the level from a 65% to 97% of GDP in 2010. Debt will reach its maximum level at about 124% in 2013, stabilizing afterwards for some time.

Structural measures have also been approved in order to restore competitiveness and growth, although in this field the Irish economy is less needed of radical measures than other periphery economies, being already quite liberalized. Measures to boost job creation include the reduction of the minimum wage by 1 euro to €7.65 and the reform of the welfare system so as to avoid unemployment traps and promote incentives to work. Another action point relates to improving competition in services.

Portugal

Portugal also suffered in 2010 substantial market pressures and announced fiscal measures in three different waves so as to meet targets set at -7.3% of GDP in 2010 (lowered from -8.3% in May) and -4.6% in 2011, after a deficit of -9.3% in 2009. The stability program approved in January did not include a major consolidation in 2010, as most of the adjustments were delayed until 2011 (as in large eurozone countries) in order to wait for the recovery to be sustainable. In May, after the Greek crisis, Portugal had to frontload some of the consolidation measures expected to start in 2011. By the end of September, the Portuguese government had to react again with new and detailed measures for 2010 and mostly for 2011 so as to restore market confidence.

The measures announced for 2011 amount to 3% of GDP, more than enough to fill the required structural consolidation, and also to compensate for the fact that the cyclical deficit will not improve in 2011 over 2010 (assuming that GDP will decline by -0.7% in 2011). Measures include wage reductions (with an initial purpose of restricting wage increases below inflation, extended later to reducing salaries to politicians and managers of public companies and to cut civil servant wages by an average of 5%), a hiring freeze, delays in infrastructure projects and a closer control of social benefits such as unemployment subsidies. On the revenue side, VAT was increased (a 1 pp in July 2010 and 2 pp further in January 2011) and income and corporate taxation was raised. The Portuguese government also plans to raise revenues through a privatization plan.

The detailed measures announced in late September for 2011 are expected to raise €1.7bn (1% of GDP) in revenues while expenditures will be reduced by €3.4bn (2% of GDP), to try to make sure than even in a very weak growth scenario, the target of a 4.6% deficit will be met.

Regarding debt levels, they are still relatively low as compared to Greece, Ireland or Italy. In our baseline scenario the debt ratio will reach a peak 90% of GDP in the medium term and stabilizing at around level by 2015.

Spain

The Spanish government has also shown a strong commitment to restore public finances, after the improvement of fiscal balance by the Central government and the Budget approved for 2011 we expect further corrections in coming years and is expected to reach the 3% target by 2013. The main source of concern has been with regional governments, but tight controls imposed by the Central government will make the scenario of fiscal slippages more unlikely. The adjustment of public finances in 2010 came through the contention of current expenditures, the elimination of certain tax allowances and the increase of the VAT in July.

Spanish Government debt will continue to increase up to 2013 when it will reach its maximum level at a level a little above 70% of GDP, amongst the lowest levels of the eurozone, and from then on it will slowly start a downward path.

Spain has also gone through important structural reforms in 2010, most of them are still under way and will need some time to develop until a significant impact on the real economy is visible, but for the most part, these reforms go in the right direction. Regarding the financial system, the Government has announced several actions aimed at speeding up the restructuring of a part of the system. Some of these include the possibility of converting savings banks into full fledge banks and raising core capital requirements. Although some details are still to be determined, these are positive moves, that should draw a clear roadmap for how the process will develop and that should have a positive impact on the Spanish economy, increasing efficiency in the system and reducing the pressure on government debt. With regard to the long-term sustainability of public finances, it is worth mentioning that the government has sent to Parliament an ambitious proposal to reform the pension system that includes an increase in the retirement age (from 65 to 67 years old), raising the number of years needed to contribute to receive 100% of the pension (from 35 to 38,5 years of contributions) and those used to calculate the pension (from the last 15 to the last 25). Finally, the Government is also taking measures in order to boost competitiveness through changes in the labour market and through the implementation of the Services Directive. Also with regard to the labour market, some changes are expected regarding collective bargaining (March), aiming at a more flexible labour market that succeeds in linking wage and productivity growth.

Box 4: On debt dynamics

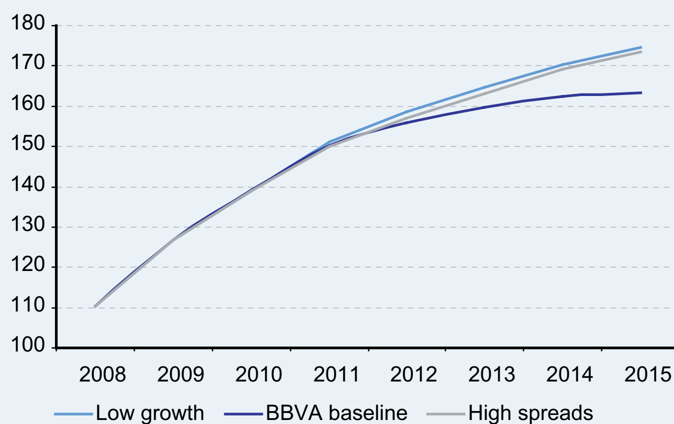
This box shows a simulation exercise of debt dynamics in several eurozone countries, so as to assess sustainability. The benchmark is the debt dynamics incorporating our baseline baseline scenario for growth, inflation and interest rates. We use our own estimation of cyclical deficits but take the plans structural fiscal adjustment as provided in government stability plans.

For interest rates, we assume that current spreads remain unchanged during 2011 and converge to "equilibrium" spreads by 2013. This equilibrium spreads are set above levels prior to the start of the crisis, and are applied to our forecast for German bund rates that are expected to increase slowly over the 2011-15 horizon.

The baseline scenario indicates that most periphery countries will face a deficit slightly above government projections, as the interest rate bill is higher due to above expected spreads and our estimation of the cyclical component is also more negative. Public debt to GDP ratios will be increasing up-to 2013 and 2014 and then start a weak downward trajectory, though with substantial disparities across countries

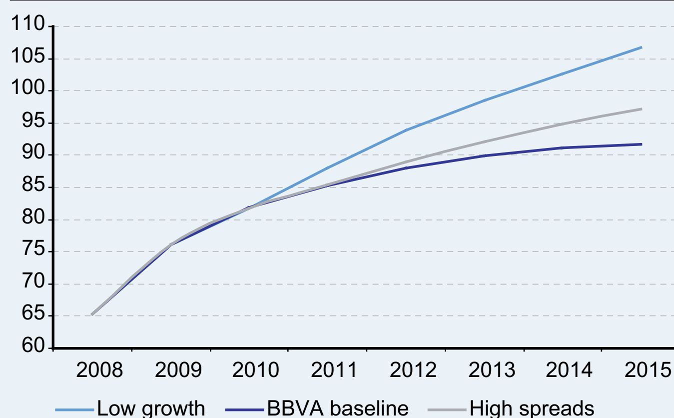
Against this benchmark, alternative paths are calculated for different GDP growth dynamics and higher sovereign spreads. One alternative scenario is that GDP growth is 1 pp lower every year than in the benchmark, which results both is a lower denominator for the ratio and higher debt (because a higher deficit). Another alternative scenario is one with higher spreads, where they are maintained constant at current levels until 2015. Although this is unrealistic (there would be some sort of policy reaction both at EU and national levels), it works as an illustration.

Chart 31
Greece: general Gov. Debt scenarios



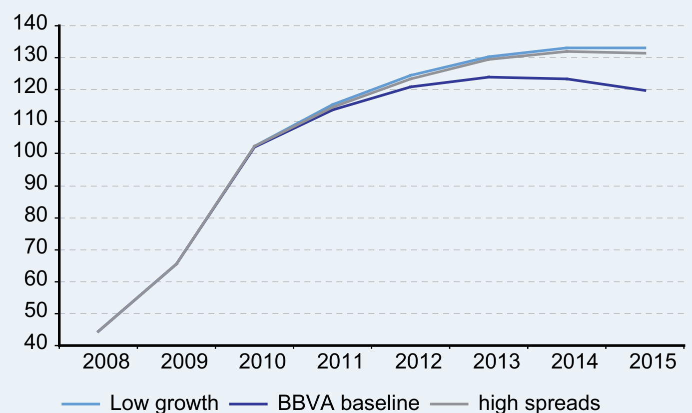
Source: National sources and BBVA Research

Chart 32
Portugal: general Gov. Debt scenarios



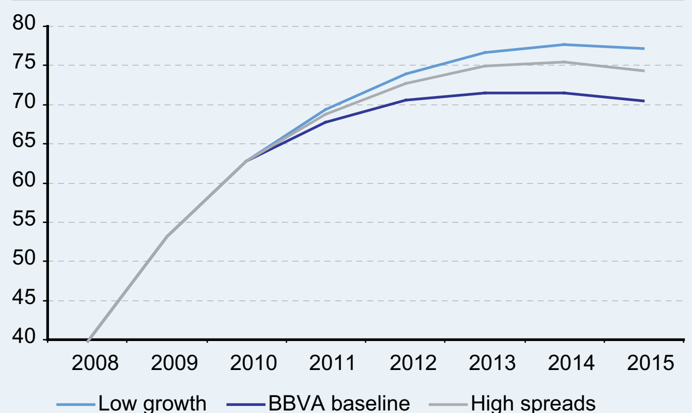
Source: National sources and BBVA Research

Chart 33
Ireland: general Gov. Debt scenarios



Source: National sources and BBVA Research

Chart 34
Spain: general Gov. Debt scenarios



Source: National sources and BBVA Research

3.3. European Governance: The need of an adequate insitutional framework to prevent crises

Part of the financial tensions that we have witnessed since September in Europe are related to an inadequate management on the side of European governments of governance issues. As it is well known, the root of the problem lies in a monetary union without fiscal union, or at least without enough fiscal coordination. This is something that was already known since the beginning of the union (see, for example, Eichengreen and Von Hagen, 1995), but had not resulted in tensions in financial markets during the first decade of the existence of the euro thanks to a favourable macroeconomic context. The main problem is the coexistence of three mutually incompatible elements, i.e. a single currency, multiple fiscal policies and the no-bailout clause in the treaties.

The Stability and Growth Pact (SGP) dealt with that problem: in order to prevent asymmetric shocks resulting in excessive public deficits, or simply to avoid fiscal profligacy, the EU devised some rules to avoid governments expanding their public deficits beyond certain limits. But, as it is well known, the SGP only worked properly during its first years of implementation as an incentive for candidate countries to reduce their high deficits, but later on it was not respected by France, Germany and others, while sanctions were not imposed. Moreover, the SGP has not been a backstop of the current fiscal problems in Europe, as these have been the result of excessive imbalances in the private sector (bubbles in different markets such as construction) rather than weak fiscal positions in the first place, as the cases of Ireland and Spain clearly demonstrate.

Market discipline has not worked as it should, either. In theory, since bailouts were not an option, markets should have been progressively more strict with those countries that with high deficits, and, above all, soaring public debt. But markets were not strict, mostly because they assumed that, in the end, European partners would not allow any sovereign state to fail. Once the crisis broke loose, markets have indeed reacted (even overreacted), applying to some countries higher spreads than those suggested by economic fundamentals.

Recent events are placed in this backdrop of tightening financial tensions. After the European Council that took place at the end of October, some European leaders started to suggest that in order to avoid investor's moral hazard a sovereign crisis resolution mechanism had to be established, which would have to include the possibility of passing part of the related costs to private investors. Even though it was made clear that such mechanism would only apply as from 2013, once the temporary EFSF would expire, the market started speculating about possible short-term sovereign debt restructuring in some peripheral countries. Only after the announcement that a deep European governance reform would take place, with a crisis resolution mechanism accompanied by a big enough permanent stability fund, has uncertainty partially subsided in sovereign markets.

After a series of rumors and debates about the final design of European governance reforms, the only clear decision from the European Council in December was the creation of a permanent stability fund as of 2013. In addition to continuing work on the reinforcement of fiscal discipline (SGP), which is expected to be finally approved in the summer, it was decided that discussions would proceed throughout the first quarter of the year to make a proposal in time for the Council's meeting at the end of March. Such proposal should contain measures not only to resolve the present crisis, but also to manage the resolution of future crisis, as well as the creation of a fiscal policy framework to complement the monetary union. There is a good deal of proposals, but, in our opinion, the new governance framework should include the following elements:

- In the short term, it is necessary not only to solve the current liquidity problems faced by several European sovereigns (and by extension by the private sector), but also to address sovereign solvency issues. Tackling solvency issues with liquidity-providing measures is not a satisfactory solution. In that sense:
  - To solve liquidity issues, the available EFSF funds should be increased to at least its nominal allotment (€440 billion, which together with other European funds and the amount that the IMF has made available could reach a total of €750 billion). Furthermore, it would be necessary to increase the flexibility of this fund, in order to allow it to intervene in secondary markets (to reduce the sovereign spreads without the need to approve a rescue program) and to diminish the applied interest rates. The latter is a crucial matter, since Greece and Ireland's experiences show that high interest rates, in a context of strong fiscal consolidation, can threaten the economic recovery. To reduce governments moral hazard (i.e. incentives to apply to a rescue program) fiscal and structural reform conditionality, like the one already in place, should be enough.

- To solve sovereign solvency issues, short-term measures are necessary aiming at restoring market confidence. To achieve this, it would be desirable that a European institution (probably the European Commission) determines, with objective criteria, which countries will be solvent after the adjustments currently taking place (within a 2013 or 2014 horizon). Once this has been determined, measures to reduce public debt ratios to sustainable levels should take place. Given the uncertainty in financial markets, it is unrealistic that this debt reduction takes place through an investor bail-in, since contagion to other sovereign accounts and to the European banking system could be a serious threat to a financial environment which is already weak. Debt reduction should be done by the rest of the eurozone countries. As an illustration, reducing the Greek public debt from 150% to 100% of GDP would be equivalent to about 1% of eurozone GDP, a small quantity. An option to implement such reduction could be the use of loans to affected countries in order for them to buy their back debt in the secondary market. Other possibilities include new long-term loans at reduced interest rates or gradual hand-ins of funds –similar to cohesion funds- subject to strict conditionality.

- In the long run, a strong future crisis prevention and resolution mechanism should be introduced:
  - With regards to crisis prevention, it is important to avoid excessive deficits in public accounts to develop, or, if these imbalances already exist, their funding should be ensured:
    - The European Stability Mechanism already in place is a good instrument, including the preventive monitoring of the fiscal situation ("European Semester"), new surveillance criteria relative to private sector imbalances (which have been the real cause of the current crisis in various countries) and public debt levels (not only deficits), as well as reinforced and automatic sanctions. This last element is key, since one of the European Council's resolutions last October regarded the possibility of reversing sanctions by qualified majority in the EU Council, something that weakens substantially the new mechanism.
    - Fiscal rules to reduce structural deficits on a national basis, possibly incorporated in the constitution, can also help, although these will be hard to harmonise across countries and cannot be linked to any sanctions mechanism. This will make any application difficult, like it has occurred in the past.
    - In the medium term, the issuing of eurobonds that cover a percentage of public debt in every country (possibly 60% of GDP) is a possibility. This, however, implies parting from the "no bailout" principle, and requires advancing towards further coordination of fiscal policy, in order for eurobonds to be politically acceptable. This, in turn, requires important changes to European treaties.
  - With regards to future crisis resolution, and in order to establish certain degree of market discipline and reduce investor moral hazard, defining mechanisms with private participation is a good idea. Nevertheless, the latter should not be drastic, so as to avoid contagion. If the reinforced preventive part does not work properly and it is necessary to restructure a country's public debt reducing the value of current private investment, collective action clauses are a good alternative. Private participation should be a credible threat, though one that should only be applied as a last resort, and preferably through less traumatic mechanisms than the mere reduction of debt (term extensions or interest rate reductions).

During the European Council of February 4th some of these issues were addressed in the discussions, but without concrete proposals presented, which have been postponed for March's meeting. In addition to these issues, there have been proposals (sponsored by the German government) to reinforce competitiveness in countries within the eurozone. These include a reform to salary determination, the standardization of the tax system (particularly the corporate tax), raising the retiring age and the establishment of fiscal rules on a national level. These proposals would aim towards the reduction of future public and private imbalances, but they are probably not essential for the creation of a European institutional framework, and are hard to coordinate among different member states. The key now is to deal with the issue of market confidence on the sustainability of public accounts in some countries. In order to achieve this, it is more important to tackle the issues described above rather than to embark on new reform proposals.

Tables

Summary of forecasts

Table 1

Eurozone (YoY)

	2008	2009	2010e	2011f	2012f
GDP at constant prices	**0.3**	**-4.0**	**1.7**	**1.7**	**1.8**
Private consumption	0.4	-1.0	0.7	1.0	1.5
Public consumption	2.3	2.4	0.7	0.4	0.7
Gross Fixed Capital Formation	-1.0	-11.3	-1.0	1.6	2.0
Inventories (*)	-0.2	-0.7	1.3	0.1	0.0
Domestic Demand (*)	**0.3**	**-3.3**	**1.7**	**1.1**	**1.4**
Exports (goods and services)	0.7	-13.1	9.7	6.9	5.7
Imports (goods and services)	0.6	-11.8	9.9	5.6	4.9
External Demand (*)	**0.1**	**-0.8**	**0.0**	**0.6**	**0.4**
Prices and Costs					
CPI	3.3	0.3	1.6	1.8	1.6
CPI Core	2.4	1.3	1.0	1.4	1.3
Labour Market					
Employment	1.0	-1.8	-0.4	0.4	0.6
Unemployment rate (% of labour force)	7.6	9.5	10.0	10.0	9.9
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-2.0	-6.3	-6.5	-4.7	-3.9
External Sector					
Current Account Balance (% GDP)	-1.1	-0.7	-0.5	0.0	0.1

* Contribution to growth
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2008	2009	2010e	2011f	2012f
United States	0.4	-2.6	2.8	3.0	2.7
EMU	0.3	-4.0	1.7	1.7	1.8
UK	-0.1	-4.9	1.4	1.7	1.9
Latin America *	4.0	-2.4	6.0	4.4	3.9
EAGLES **	6.6	3.5	8.3	7.0	6.8
Turkey	0.7	-4.7	7.6	4.5	4.5
Asia Pacific	5.6	3.7	8.1	6.5	6.4
China	9.6	9.2	10.3	9.2	9.0
Asia (exc. China)	2.9	0.1	6.7	4.8	4.7
World	3.0	-0.6	4.8	4.4	4.4

Forecast closing date: January 31st, 2011
*Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2008	2009	2010e	2011f	2012f
United States	3.8	-0.3	1.6	1.3	1.5
EMU	3.3	0.3	1.6	1.8	1.6
UK	3.6	2.2	3.3	3.3	2.1
Latin America *	7.7	7.0	7.7	8.0	8.1
EAGLES **	7.4	2.8	5.2	5.2	4.8
Turkey	10.4	6.3	8.6	6.6	6.1
Asia Pacific	5.7	0.3	3.5	3.8	3.5
China	5.9	-0.7	3.3	4.5	4.0
Asia (exc. China)	5.5.	1.0	3.7	3.3	3.2
World	6.1	2.2	3.6	3.7	3.5

Forecast closing date: January 31st, 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Current Account (% GDP)

	2008	2009	2010e	2011f	2012f
United States	-4.7	-2.7	-3.4	-3.5	-3.4
EMU	-0.9	-0.6	-0.5	0.0	0.1
Latin America *	-0.3	-1.8	-1.0	-1.1	-1.4
EAGLES **	3.9	2.4	2.1	1.9	1.6
Turkey	-5.6	-2.2	-5.9	-5.7	-4.9
Asia Pacific	4.8	3.8	3.0	3.3	3.2
China	9.9	6.1	4.6	5.1	5.0
Asia (exc. China)	1.4	2.3	2.0	2.2	2.0

Forecast closing date: January 31st, 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Government Deficit (% GDP)

	2008	2009	2010e	2011f	2012f
United States	-3.2	-10.0	-10.2	-10.1	-6.8
EMU	-2.0	-6.3	-6.2	-4.4	-3.7
Germany	0.0	-3.3	-3.6	-2.5	-2.2
France	-3.3	-7.5	-7.5	-6.0	-5.3
Italy	-2.7	-5.3	-4.5	-3.6	-2.8
UK	-4.9	-11.5	-10.7	-8.8	-6.6
Latin America *	-0.9	-6.0	-1.5	-1.5	-1.1
EAGLES **	-1.8	-5.5	-3.7	-3.1	-2.5
Turkey	-1.8	-5.5	-3.6	-3.3	-3.3
Asia Pacific	-2.8	-5.1	-4.8	-4.2	-3.5
China	-0.4	-2.8	-2.8	-2.3	-2.1
Asia (exc. China)	-4.4	-6.5	-6.1	-5.4	-4.5

Forecast closing date: January 31st, 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 6

Financial variables

Official Interest Rates (End period)	2008	2009	2010	2011f	2012f
United States	0.61	0.25	0.25	0.25	0.50
EMU	2.73	1.00	1.00	1.00	1.00
China	5.31	5.31	5.81	6.56	7.06
10-year Interest Rates (Avg).					
United States	3.6	3.2	3.2	3.4	3.8
EMU	4.0	3.3	2.8	3.1	3.1
Exchange Rates (US Dollar per national currency)					
United States (EUR per USD)	0.68	0.72	0.76	0.79	0.78
EMU	1.47	1.39	1.33	1.27	1.29
UK	1.82	1.56	1.55	1.53	1.52
China	6.95	6.83	6.77	6.46	6.10

Forecast closing date: 31st January 2011
Source: BBVA Research

Germany

Table 7

GDP growth and inflation forecasts

YoY rate	2008	2009	2010e	2011f	2012f
Private consumption	0.6	-0.1	0.2	1.3	1.4
Public consumption	2.3	2.9	2.4	0.8	0.9
Gross Fixed Capital Formation	1.8	-10.0	5.8	6.0	4.3
Inventories (*)	-0.2	0.1	0.7	0.0	0.0
Domestic Demand (*)	**0.9**	**-1.5**	**2.3**	**2.1**	**1.8**
Export	2.0	-14.3	14.4	7.4	7.1
Import	2.9	-9.4	13.1	7.5	7.7
Net export (*)	**-0.2**	**-3.2**	**1.2**	**0.3**	**0.1**
GDP	**0.7**	**-4.7**	**3.5**	**2.4**	**1.9**
Inflation	**2.8**	**0.2**	**1.2**	**1.8**	**1.4**

(*) Contribution to growth
Source: BBVA Research

France

Table 8

GDP growth and inflation forecasts

YoY rate	2008	2009	2010e	2011f	2012f
Private consumption	0.5	0.6	1.6	1.5	1.7
Public consumption	1.6	2.8	1.4	0.4	0.5
Gross Fixed Capital Formation	0.3	-7.0	-1.6	2.4	3.1
Inventories (*)	0.3	-1.9	0.1	0.1	0.0
Domestic Demand (*)	**0.4**	**-2.4**	**1.1**	**1.6**	**1.8**
Export	-0.8	-12.2	9.9	6.3	6.4
Import	0.3	-10.6	7.7	5.8	5.7
Net export (*)	**-0.3**	**-0.2**	**0.4**	**0.0**	**0.0**
GDP	**0.1**	**-2.5**	**1.5**	**1.6**	**1.8**
Inflation	**3.2**	**0.1**	**1.7**	**1.7**	**1.6**

(*) Contribution to growth
Source: BBVA Research

Italy

Table 9

GDP growth and inflation forecasts

YoY rate	2008	2009	2010e	2011f	2012f
Private consumption	-0.8	-1.8	0.5	0.8	0.9
Public consumption	0.8	0.6	-0.5	0.1	0.2
Gross Fixed Capital Formation	-4.0	-12.2	2.5	1.6	1.8
Inventories (*)	-0.3	-0.4	0.3	0.0	0.0
Domestic Demand (*)	**-1.4**	**-3.8**	**1.0**	**0.8**	**0.8**
Export	-3.9	-19.1	7.8	5.1	5.2
Import	-4.3	-14.6	7.1	4.1	3.9
Net export (*)	**0.1**	**-1.2**	**0.1**	**0.2**	**0.3**
GDP	**-1.3**	**-5.1**	**1.1**	**1.0**	**1.1**
Inflation	**3.5**	**0.8**	**1.6**	**1.7**	**1.8**

(*) Contribution to growth
Source: BBVA Research

Portugal

Table 10

GDP growth and inflation forecasts

YoY rate	2008	2009	2010e	2011f	2012f
Private consumption	1.8	-1.0	1.7	-1.4	0.0
Public consumption	1.1	3.4	2.4	-4.3	-0.9
Gross Fixed Capital Formation	-1.8	-11.6	-4.5	-5.2	0.1
Inventories (*)	0.3	-0.6	-0.3	-0.1	0.0
Domestic Demand (*)	**1.3**	**-3.2**	**0.5**	**-2.9**	**-0.2**
Export	-0.3	-11.7	9.3	6.4	6.6
Import	2.8	-10.6	4.7	-1.0	3.1
Net export (*)	**-1.2**	**0.7**	**0.9**	**2.4**	**1.0**
GDP	**0.0**	**-2.5**	**1.4**	**-0.5**	**0.9**
Inflation	**2.7**	**-0.9**	**1.4**	**2.1**	**1.2**

(*) Contribution to growth
Source: BBVA Research

Spain

Table 11

GDP growth and inflation forecasts

YoY rate	2008	2009	2010e	2011f	2012f
Private consumption	-0.6	-4.3	1.1	0.2	1.2
Public consumption	5.8	3.2	0.0	-0.6	-0.3
Gross Fixed Capital Formation	-4.8	-16.0	-7.6	-2.9	3.4
Equipment and other products	-3.0	-21.2	-2.4	0.6	5.0
Construction	-5.9	-11.9	-11.1	-5.3	2.3
Housing	-10.7	-24.5	-17.3	-7.1	4.1
Other construction	-0.8	-0.1	-6.7	-4.1	1.0
Inventories (*)	0.1	0.0	0.0	0.0	0.0
Domestic Demand (*)	**-0.6**	**-6.4**	**-1.1**	**-0.7**	**1.4**
Export	-1.1	-11.6	9.0	9.1	7.0
Import	-5.3	-17.8	4.4	2.0	4.6
Net export (*)	**1.5**	**2.7**	**1.0**	**1.6**	**0.5**
GDP	**0.9**	**-3.7**	**-0.2**	**0.9**	**1.9**
Inflation	**4.1**	**-0.3**	**1.8**	**1.9**	**1.3**

(*) Contribution to growth
Source: BBVA Research

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