BBVA | RESEARCH

Economic Outlook

Europe

Fourth Quarter 2012
Economic Analysis

- **The measures approved by the ECB** have dispelled significantly the euro break-up risk.
- **Advances towards a higher banking and fiscal integration require a political agreement in Europe,** while peripherals should continue with the reforms at an appropriate pace.
- **The eurozone is in recession,** but financial strains have diminished thanks the measures announced.
- **Growth will return in 2013,** but at a slow pace.
- **The eurozone periphery will continue to be in recession** due to the need of deleveraging.
- **The lack of definition on the future of EMU and the periphery crisis** also drag down growth in core countries.

Index

Closing date: November 8, 2012

1. Editorial

The roadmap towards the resolution of the European crisis has been redrawn since the announcement by the ECB of its willingness to buy sovereign bonds in order to eliminate the "convertibility risks" of the euro. Tensions in financial markets have eased significantly, and the likelihood of a tail-risk scenario that would lead to a strong GDP fall has been greatly reduced. Nevertheless, the crisis is far from being resolved, and the hurdles are still numerous, but the ECB's actions have opened a window of opportunity that gives greater leeway to pursue the strategy chosen by Europe to solve its institutional problems.

This "German" strategy continues to be based on three pillars. The main pillar, and what distinguishes it from more accommodative strategies adopted by the US and the UK, is that countries with significant imbalances (mainly fiscal and external) continue to accomplish, on the one hand, fiscal adjustments to reduce deficits and stabilize public debt ratios; and second, structural reforms that help increase their competitiveness and their growth potential. The reforms adopted so far by peripheral countries have been important, especially in labour markets, and fiscal efforts carried out since 2010 are unprecedented in developed economies, despite the fact that those headline fiscal targets are not being kept to the letter. The idea of slowing some fiscal adjustment, which is already being applied in Italy, Portugal, Greece and Spain, seems appropriate, as well as focusing on structural deficit targets rather than headline ones, so that excessive deficits stemming from cyclical factors should not be offset.

The second pillar of this strategy is the reform of European institutions that would lead to banking and fiscal integration, which are deemed necessary to complement the monetary union. In recent months, some developments have focused on the common supervision of the banking system, to be implemented by the end of 2013. However, there has been little news about other aspects of a banking union (e.g. entities in crisis resolution or deposit insurance). On the fiscal union, there have been no breakthroughs since early this year, when the Fiscal Pact that requires countries to balance their deficit in structural terms was signed. No further progress was made in the most recent European summit, so a more concrete plan can be expected at the December summit. However, Germany's lack of willingness to talk in advance about the mutualisation of public debt (expected to end-up with the introduction of Eurobonds), and France's reluctance to accept centralized budgets does not bode well for decisive results later this year. It seems clear that following the ECB's action in June, the reduction of financial tensions has made institutional reform less urgent.

The third pillar of the strategy focuses on the provision of liquidity to countries in crisis. In this sense, the implementation of the permanent bailout fund (ESM) in October was backed by the German Constitutional Court. But beyond the ESM, the ECB's willingness to purchase sovereign debt (under strict conditionality and aimed at restoring the transmission mechanisms of monetary policy), may solve two problems; first, the liquidity problems perceived by market participants due to limited funding from the EFSF and the ESM; and second, the need for national parliaments to approve each new aid package.

Overall, this strategy attempts to reconcile the continuing pressure for further adjustments in the periphery and financial support to counter the excessive pessimism of the market. Although one can argue whether this is the best strategy (compared, for example, to faster integration based on Eurobonds, or to more expansionary policies in countries that can afford it), it is probably the only way to maintain the political balance between different countries in the region. The layout plan is working slowly, but further progress is needed on all fronts and potential accidents on the road must be avoided. Regarding that last point first we must mention the situation in Greece, whose exit from the eurozone – what seems unlikely in the short term– would cause a significant contagion effect on the rest of the area; and second, if the ECB opts to withdraw its support to those countries that may have asked for aid and are unable to comply with the conditionality. If that occurs, Europe can find itself facing a new crisis and with no ammunition.

Although a fragmentation in financial markets persists, the recent easing of financial stress due to the fall in spreads on sovereign debt may boost the European economy somewhat in 2013. Although the most recent activity data has been somewhat worse than expected and the eurozone is in recession, our forecast is that this new window of opportunity will drive the eurozone to grow slowly at the beginning of 2013, Activity will be supported by global growth, which will remain robust in 2013, especially in emerging countries, and will benefit from the recently announced monetary expansion in the United States. Overall, we believe that Europe could grow by around 0.3% in 2013, after falling -0.5% in 2012. By countries, differences across the core and periphery will remain. The latter will be subject to more restrictive financial conditions, and to additional fiscal adjustments.

2. Global economy: bold actions by central banks make tail-risk scenarios less likely

Bold actions by central banks have clarified the global economic outlook but challenges remain for policy makers to avoid setbacks

The world economy is expected to continue its soft recovery with a GDP growth rate of 3.5% in 2013 (3.2% in 2012, 4.2% on average in 2010-12). It is supported by lower risk aversion, following the meaningful decisions taken by central banks, especially the ECB. However, three factors stand out among those that could make this outlook deteriorate significantly: first and foremost, troubles in Europe, if the euro break-up fears that loomed large during the first half of the year among market participants resurface; second, in the US, the still-hanging threat of the so-called fiscal cliff, i.e., a spending-cut and tax-hike package worth 4% of GDP due to come into effect at the beginning of 2013 that would push the US economy back into recession; third, a severe slowdown in the emerging economies, in particular in China and some commodity-oriented economies, if Chinese appetite for raw materials decreased.

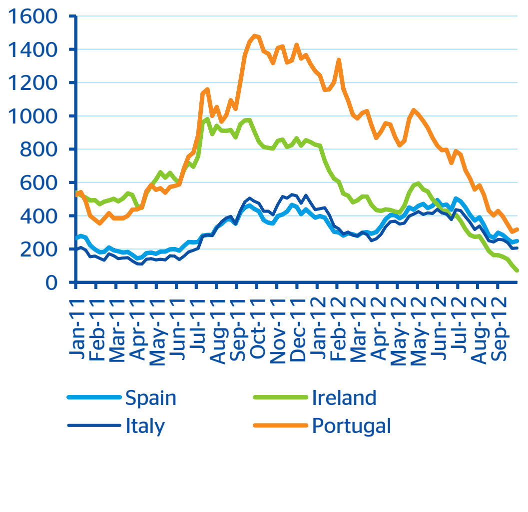
Central bankers to the rescue; other policy makers should follow suit

Against a backdrop of high uncertainty and threats to the world economy, over the past months authorities across the world – in particular central bankers in the eurozone and the US – have taken significant steps forward. Those bold measures have spared the world economy from a systemic event that would have been comparable with the financial developments of late 2008. Both central banks have built bridges: to a new institutional environment in the case of Europe and to a new fiscal pact in the US; these actions have paved the way for other policy makers to use their room of manoeuvre. However, the Fed's actions are more open-ended that the ECB's due to different conditionality: strict fiscal fulfilment is compulsory in Europe, whereas labour market improvement is the objective in the US.

"…whatever it takes…"

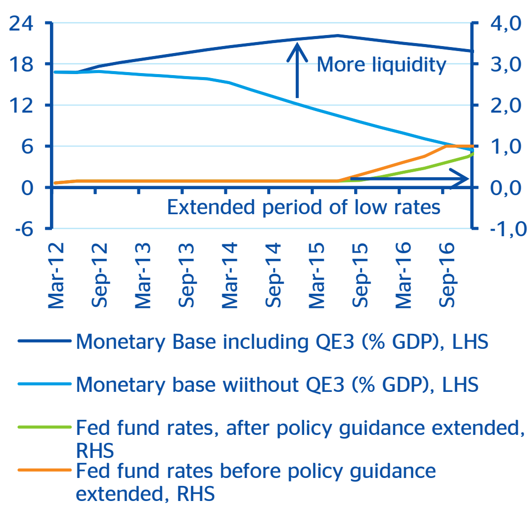
As described in Chapter 3, when the ECB President Mario Draghi announced the implementation of a new bond-purchase programme (Outright Monetary Transactions, or OMT) in late July, the institution took a decisive step to put an end to the debt crisis in Europe. Under certain conditions (see our September ECB Watch for further details), the ECB could intervene in the secondary markets. The ECB's move came after a eurozone summit in June where leaders reached some agreements to reinforce the currency union: a broad roadmap towards a single banking supervision, far-reaching plans covering fiscal issues and growth-supporting measures. The rationale behind Draghi's announcement is clear. Yields on some peripheral bonds are elevated because markets are partly pricing in eurozone break-up fears (Chart 1), compromising the ECB's mandate amid a severe financial fragmentation. Since that is "unacceptable," the ECB has committed itself to buy unlimited quantities of sovereign bonds of those countries that seek financial aid from Europe's funds (European Financial Stability Fund & European Stability Mechanism) with "strict and effective conditionality". The existence of a lender of last resort under fiscal conditionality dispels fears of the reversibility of the euro in its current configuration.

Chart 1
Financial Stress Index for eurozone countries[1]



Source: BBVA Research

Chart 2
QE3 and extended policy guidance



Source: BBVA Rresearch

"...as long as needed..."

With the US economic growing at low rates, the unemployment rate remaining persistently high and amid huge uncertainty in Europe, a pre-electoral gridlock over how to bring the whopping US deficit down was the last thing the US economy was in need of. Against this backdrop, the Fed did not hesitate. First, and in accordance with its "forward-guidance policy," the Fed announced that it intends to keep interest rates at its current low levels at least until mid-2015. Second, the Fed announced a new round of quantitative easing (QE) (Chart 2) to support growth and employment recovery.

The further monetary loosening will be different from previous rounds. First, the Fed will purchase mortgage-backed securities (MBS) rather than Treasuries in an attempt to improve financial conditions for households. Second, the Fed will continue with this policy for a considerable period of time, even after the recovery strengthens and the labour market improves substantially; i.e., it will not give up buying MBS when growth starts picking up (see our US Fed Watch for further details).

In our view, by embarking on QE3 and extending policy guidance, the Fed is buying insurance against the "fiscal cliff," but it is not a silver bullet if not accompanied by fiscal actions. In our baseline scenario, an agreement will be reached to avoid the complete package of automatic spending cuts and tax hikes from taking place. Yet we also expect some form of fiscal consolidation that will drag the economy down. With QE3 and policy guidance, the Fed does its part to give the economy the boost it needs to avoid slipping back into recession in 2013. In fact, according to our estimates, monetary loosening could contribute just a few tenths of a percentage point (pp) to GDP growth in 2013, but from 2014 onwards the effect will be more substantial. Regarding inflation, the impact will be small and delayed. However, it seems to us that the Fed's tolerance to higher inflation will depend on growth and labour market improvement (see our Global Economic Outlook for further details).

1: The BBVA Research Financial Stress Index (FSI) is a synthetic indicator that summarizes movements of: risk measures (5-year CDS, CDS of non-financial corporations and financial debt), volatility (stocks, interest rates and exchange rates) and liquidity stress (spread between interbank rate and free-risk asset at 3-months term).

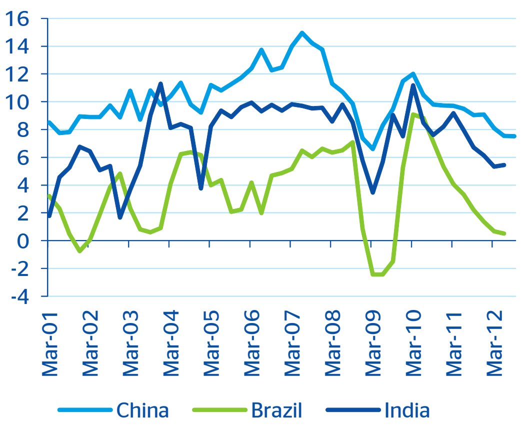
The potential effects of QE3 are not restricted to the US economy. As previous programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs in those countries, boosting the availability of credit, their growth rates and also their inflation. Our estimates show that QE3 (plus the Draghi effect) could have a lower impact than QE1 due to comparative evolution of risk premium and capital inflows in the emerging economies. In any case, that will depend on domestic-policy response to capital inflows.

Central bankers' responses are not enough to bring the global economy back to a firm expansion

Thanks to the economic policy measures, the world economy may have avoided decelerating to the slowest growth in the last 30 years (apart from the 2009 recession) but the low growth environment continues. The advanced economies have been losing momentum since 2011 as one should expect given the current deleveraging environment. More recently the emerging economies have been hit too. In this regard, the trade channel has been intense in bringing exports and GDP growth down (Chart 3).

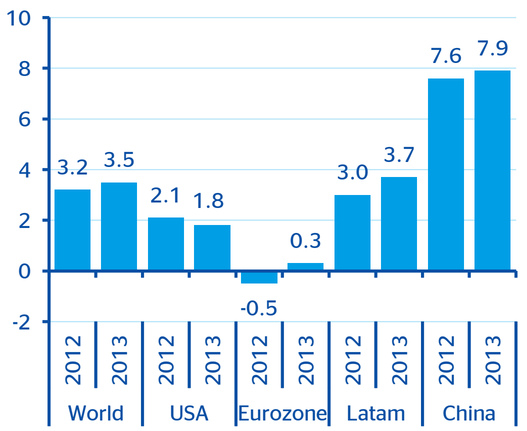
Certainly that is the case in the three largest emerging economies. Brazil's economy almost stalled in the first half of the year; India's GDP grew by 5.3 and 5.5% y/y in the first and second quarter, respectively, the slowest pace since the beginning of 2009; and in the third quarter of the year the Chinese economy slowed to a rate of 7.4%, the lowest growth rate since 2009 although the most recent data points to a bottoming-out.

Chart 3
Emerging economies: GDP growth rate (% y-o-y)



Source: BBVA Research and Haver

Chart 4
GDP growth rate



Source: BBVA and Haver

However, the actions that have been taken by central banks in the US and in the eurozone are partly dispelling some doubts and improving the outlook. Under our baseline scenario, growth in the eurozone is likely to gain momentum in 2013. In the US, we have maintained our forecasts; growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2pp in 2012 and -0.4pp in 2013), although its growth rate will remain close to 8% both years due to expected policy stimulus to partly compensate the slowdown. Other emerging economies will make up for this slack: the outlook for growth in Latin America is revised slightly upwards in 2013, when the region will grow by 3.7%, up from a 3% growth rate in 2012. All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5% in 2012 and 2013, respectively (Chart 4).

3. Progress towards a solution of the eurozone crisis

High financial tensions and market fragmentation in early summer

Early in the third quarter, financial markets were strained, in particular the European debt markets. The main factor behind the deterioration of market conditions was, once again, sovereign risk, in this case focused on Spain and Italy, with growing divergence between the core countries of Europe and the countries of the periphery. Interest rates of sovereign debt in Spain and Italy reached levels higher than those of rescued countries at their peak, while core countries experienced negative rates on the short segment of the curve. Not only Germany acted as a safe asset, but also debt from countries like France or Belgium gained this status. Financial tensions were also felt in other markets. The feedback loop between bank and sovereign risk became evident again with the increase in bank CDS. Similarly, the lack of a proper functioning of the interbank market and the capital outflows from peripheral countries led to an increase in the recourse of these countries to ECB funding.

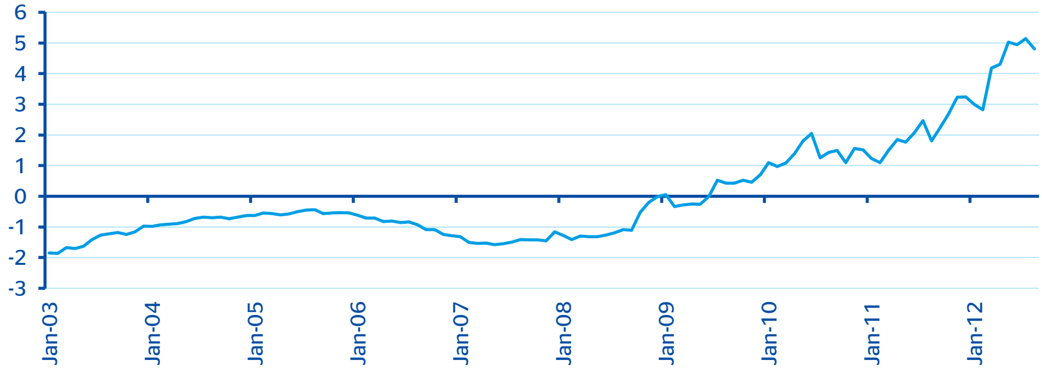
The increase in the Eurosystem TARGET 2 positions is a clear indication of the high degree of financial fragmentation in the eurozone. High interest rates level reached by the peripheral countries debt, well above what fundamentals would explain, demonstrated that the market was discounting not only sovereign risk, but also a convertibility risk.

The ECB readiness to buy sovereign debt implies a radical change in the prospects of a crisis solution

Under this scenario, the ECB adopted two decisions. First, in July, faced by the increase of downside risks in activity, it reduced official interest rates from 1%, which had been the lower limit until recently, down to 0.75%, leaving unchanged the corridor at + - 75 bp for the marginal and deposit rate and setting the deposit rate at 0%. This was one of the factors that added downward pressure to short interest rates of core countries. Second, and more importantly, it announced a new (conditional) bond purchase programme of up to 3 year bonds, the OMT, which is a clear turning point in the approach of the ECB towards the resolution of the European crisis. This is so because of two reasons: First, the ECB publicly admitted that markets are discounting a convertibility risk, contributing to market fragmentation (Chart 5) and hence hampering the transmission mechanism of monetary policy. Second, because this programme entails unlimited liquidity support for eurozone sovereigns, unlike the European bailout funds (either the transitional EFSF, or the permanent ESM) whose amounts are limited and have been questioned by the market as insufficient to address the debt crisis. For both reasons, the announcement of the ECB constitutes very good news.

Despite the positive news, the ECB's plan raises some doubts. It is a conditional intervention, i.e. it is subject to the request for assistance to the ESM/EFSF (specifically, a precautionary line of reinforced conditionality, or ECCL+), and its maintenance is also subject to the compliance with the conditions agreed under this assistance programme. In addition, intervention is limited to the short end of the curve.

Chart 5
Composite measure of Euro Area financial divergence



* Components; (i) the cross country coefficient of variation of bank lending rates to corporates and households (average) (ii) the Target 2 balances of surplus (iii) gross liquidity provision by Eurosystem as a share of bank assets and (iv) the interquartile range of Euro area countries' two-year government bond yields. To combine these varied indicators, we calculate a Z-score for each, and then estimate the first principal component of these Z-scores.
Source: BBVA Research

Market reaction to the ECB announcement has been favorable and funding conditions have improved

In any case, the sheer announcement effects have been sufficient to reduce the probability of a tail risk scenario and to address the tensions in financial markets (Chart 1). Debt rates of the peripheral countries have fallen substantially, to 300 bp in two-year bonds, and up to 200 bp in ten year bonds. Similarly, there has been a narrowing of sovereign and bank CDS's in peripheral countries, indicating a reduction in the probability of default. The correction has also been observed in the upward movement of rates of core countries, though they still stand at low levels. However, after the strong initial improvement in markets prompted by the ECB announcement, most recently the situation has stabilized and further improvement is unlikely without a new trigger.

Signals are also positive, although still incipient, in relation to the funding capacity of both the public and the private sectors (banking and non-banking). In the latter case, a partial reopening of markets for banking and corporate sector emissions has been observed over the last two months. Thus, signs of slight normalization begin to be noted in emissions markets, although financing costs are high and the maturities of issuances are still short. In any event, although the reduction of the financial tensions and the reopening of markets are good news, there is still a long way to restore the normalization of markets and to reduce the current high level of market fragmentation.

ECB's action must support progress on other fronts: greater integration and reducing imbalances in the periphery

The decision by the ECB responded to a situation of maximum tension in financial markets, and took place only after an agreement were reached at the EU summit in late June on further progress towards a greater fiscal and banking integration. The ECB's plan must be understood as a window of opportunity towards greater integration in Europe and reduced imbalances in order to tackle the European debt crisis. In this regard, the ECB's action is a necessary, but not sufficient condition, and therefore it must be backed by progress on other fronts.

After summer, there has been some progress in this direction. On the one hand, the ESM has been launched in October, after being ratified by all member countries, in particular by Germany, where ratification was pending on the approval by the Constitutional Court, which did it in early

September. The new European rescue fund will coexist for a limited period with the previous one (EFSF), will strengthen the resources available for new interventions (up to 500 billion euros beyond those already committed) and enjoy greater flexibility, as the ESM can intervene in primary and secondary sovereign debt markets. All these decisions were taken in previous summits.

Second, the October summit has taken some steps, though modest, towards greater fiscal and banking integration. On the fiscal union there has been substantial progress. The possible mutualisation of public debt through eurobonds or similar mechanisms (eurobills or debt redemption fund proposed by some German economists), widely discussed in the past, has not been mentioned in the official statement and has disappeared from recent statements by politicians even as a possibility in a final stage of the fiscal union, though it must not be ruled out that it reappears in the debates that will precede the summit of December. The counterpart for debt mutualisation is a centralized fiscal discipline, through a European commissioner with veto power over national budgets, and it was a proposal of the German finance minister before the summit, but did not appear in the statement, and it is doubtful that it was easily accepted by countries like France.

On banking, European leaders reached an agreement in June on direct recapitalization of banks with ESM funds which would have broken the sovereign-banking feedback loop affecting countries with weak financial sectors, in particular Ireland and Spain. Recently, however, some core countries have raised doubts about its implementation, and in October it became clear that direct recapitalization would occur when the new common banking supervision mechanism was launched. However, the calendar will not be published until January, so the new supervisory body will probably not be operational until late 2013. In the coming months, other issues relating to the banking union should also be addressed, although there is disagreement about its scope. Among the four potential areas of integration (joint supervision, common regulation, a common body for the dissolution of banks and pan-European deposit guarantee fund), the most advanced discussions relate to the new banking supervision mechanism. The ECB will play a decisive role, although there is no consensus on how to deal the role of national supervisors. The authorities should reach an agreement on other issues, such as representation and voting power of countries outside the euro zone, ECB's liability against the European institutions under the supervision mechanism and the final status of the European Banking Authority. Agreements on the resolution of banks and deposit guarantees mutual fund have not yet been reached, and it does not seem that negotiations will soon bear fruit.

Despite the progress, risks persist: Greek situation ...

Despite the progress made, many of the uncertainties have not been completely dispelled. On the one hand, the situation of the crisis in Greece had improved and, at least in the short term, there Greece will not leave the euro, but the Greek fundamental remain weak.

The new Greek government has prepared a package of fiscal measures for the next two years for 13.5 billion euros, which is about to be approved by parliament; while attempting to take further steps towards a more flexible labour market, as required by the troika. In return, the EU is likely to give Greece two more years (until 2016) to achieve the target of reducing the public deficit below 3%. This will entail new financing needs and it is not yet clear how they will be covered. In principle, it seems that a debt restructuring in official hands (especially the ECB and the EFSF) will not be approved in the short term, although interest rates conditions may be soften, debt could be repurchased in secondary markets, or Greece could increase the issuance of short-term debt.

... and the ECB conditionality

Another source of uncertainty is linked to the conditionality that the ESM and ECB would request to Spain or Italy in case they ask for financial aid, and especially what would happen if the conditionality is not strictly enforced. The ECB President noted that the central bank would halt its debt purchases, but this would probably that would trigger new doubts about the irreversibility of the euro. This is essential, since it is not ruled out that some countries in the euro area periphery will comply to the letter with its fiscal targets, given the tax fatigue accumulated in the past two years and the recessionary outlook in these economies. This is the case of Spain, whose government is committed to a deficit reduction of 1.8 percentage points in 2012 and 1.3 pp in 2013 (excluding bank support), which implies much greater fiscal effort, given the cyclical deterioration. Our scenario foresees that, unless further tax action is taken, Spain will fail to fulfil these objectives. Likewise, if new fiscal consolidation plans were implemented in the periphery, the recession could worsen, and if fiscal multipliers are larger than expected, the fulfilment of the objectives would be even more difficult to achieve.

Table 1
Eurozone Budget monitor

Germany

		2010	2011	2012	2013		Comments
Government Deficit Target	% of GDP	-4.1	-0.8	-0.5	-0.5	1.	
BBVA Forecast				-0.4	-0.4		
Interest payment		-2.5	-2.5	-2.3	-2.2	2.	
Cyclical		-0.7	0.2	-0.1	-0.3		
Cyclically adjusted excl. Interests		-0.9	1.6	2.1	2.1		
Structural adjustment			2.5	0.3	-0.1		
General Government Debt		82.5	80.5	83.3	81.2	3.	
Central budget execution (y.t.d.)	bn €	-34.5	-26.2	up to Sep-12		4.	
	% of GDP	-1.3	-1.0				

1. Given the better than expected performance in 2011 the 2012-14 targets have been revised by the government from the SGP. The German government expects -0.5% deficit in 2012 instead of the 1% established in April under the SGP.

2. The phase-out of previous stimulus measures will do most of the job to bring back a balanced budget.

3. Debt will increase in 2012 by 2.5 pp to 80.5% of GDP partly due to the inclusion of the contributions to the EFSF/ESM and banking aid.

4. Taxes on sales and income taxes rose strongly on the back of a healthy labour market and solid consumer demand. For the period January-September 2012, tax revenues rose by 5.6% compared to a year earlier. Going forward, officials expect weaker tax revenue growth as the economy heads towards a soft patch at the end of the year.

France

		2010	2011	2012	2013		Comments
Government Deficit Target	% of GDP	-7.1	-5.2	-4.5	-3.0	1.	
BBVA Forecast				-4.6	-3.3		
Interest payment		-2.4	-2.6	-2.6	-2.7	2.	
Cyclical		-1.3	-1.1	-1.6	-2.0		
Cyclically adjusted excl. Interests		-3.3	-1.4	-0.4	1.3		
Structural adjustment			2.1	1.0	1.8		
General Government Debt		82.3	86.0	90.6	92.4	3.	
Central budget execution (y.t.d.)	bn €	-102.8	-97.7	up to Aug-12		4.	
	% of GDP	-5.1	-4.8				

1. The French Government is comitted to reduce the structural deficit to 0% in 2016. In a shorter term deficit will be reduced from 4.5% this year to 3% in 2013, that implies a 2 pp structural adjustment. We expect that this year the target will be met. However, macro assumptions for 2013 are optimistic.

2. The amount of announced measures top to €30bn (1.5% of GDP) equally distributed among families, big enterprises and the government. This fisrt year the adjstment is titled towards high income earners and it is planned to change the adjustment composition towards expenditure cuts in the medium term. Big enterprises will see their allowances and will pay more tax benefits. On the other hand, high income earners will pay 4 pp in addition on their income tax reaching the 45% for incomes above 150.000 and of 75% for those above the 1 million.

3. Debt is expected to remain at high levels and to increase due to the inclusion of the contributions to the ESM/EFSF funds.

4. Budget execution up to August hardly shows any improvement with respect last year.

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Table 1

Eurozone Budget monitor

Italy

		2010	2011	2012	2013	
Government Deficit Target	% of GDP	-4.3	-3.8	-1.7	-0.5	
Revised Sep-12				-2.6	-1.7	1.
BBVA Forecast				-2.6	-1.9	
Interest payment		-4.5	-4.8	-5.4	-5.8	
Cyclical		-0.8	-0.6	-1.5	-1.8	2.
Cyclically adjusted excl. Interests		0.9	1.6	4.2	5.7	
Structural adjustment			1.1	3.2	1.9	
General Government Debt		119.2	120.7	127.3	131.6	3.
Central budget execution (y.t.d.)	bn €	-60.9	-57.9	up to Oct-12		4.
	% of GDP	-3.9	-3.6			

Comments

1. The targets for 2012 and 2013 were revised in October from -1.7% to -2.6% and from -0.5% to -1.7%, respectively, due to worse economic activity performance. We stimate that the target for 2013 will be miss by a small margin.

2. Additional measures announced in July are showing a positive impact to improve the balance with respect last year. But the bulk of measures for 2013 include the increase in VAT by 1 pp fron July onwards. Personal income tax to lower income earners will be reduced the rate by 1pp. From the spending side, more control on the health budget, public workers contract freeze in 2013-14 and no new acquisition on residential properties, no purchase or lease of vehicles, computer consultancy restricted as well as furniture expenses and efficient use of public lights.

3. Debt is expected to increase by 7 pp of GDP , partly due to the contribution to the EFSF/ESM funds and banking recaptialization, although the Italian government expects to sell some public assets at both the national and subnational levels, with the proceeds to be used to retire public debt.

4. Latest data on budget execution from october was dissapointing, partly explained by the constribution to the rescue package for Greece. Although part of the measures announced in early September are due to be implemented by the end of the year, this latest data increases the risk of not achieving the target.

Spain

		2010	2011	2012	2013	
Government Deficit Target	% of GDP	-9.7	-9.4	-6.3	-4.5	1.
BBVA Forecast				-7.2	-5.9	
Interest payment		-1.9	-2.5	-3.1	-3.5	
Cyclical		-0.9	-1.0	-1.8	-1.8	2.
Cyclically adjusted excl. Interests		-6.8	-6.0	-2.3	-0.6	
Structural adjustment			1.3	4.4	2.1	
General Government Debt*		61.5	69.3	85.2	91.4	3.
Central budget execution (y.t.d.)	bn €	-37.6	-46.2	up to Sep-12		4.
	% of GDP	-3.5	-4.4			

* Excluding aid to the financial sector

Comments

1. Although the fiscal effort is significante, the slowdown in economic activity together with the pressures on sovereign debt the deficit in 2012 will be almost 1 pp above the target. This deviation with respect 2012 target leads to a reduction of the probabilities of reaching those for 2013.

2. In early August the governmeny presented its bi-annual program with the savings plan that amounts for €100bn for 2012 2H-2014. Measures include a raise un the general VAT by 3pp from 18% to 21%, by 2 pp the reduced to 10% and the reclassification of some of the products in the lower range to the general. Additional wage cuts to public servants.

3. Taking into account our deficit forecasts together with th transfers to the autonomous regions, public debt will be above the 85% in 2012 - excluding the financial aid to the banking sector- and of 91.4% in 2013.

4. Budget execution data at the State level up to September shows and accumulated deficit of 4.4% of GDP , 0.4 pp less than in August. Autonomous regions up to August have registeres a 0.5% deficit. In both cases it can be observed that cuts remain concentrated in investment, and to a lesser extent on intermediate consumption, and that dicretionary measures such the increase in taxes is not showing yet significant impact.

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Table 1

Eurozone Budget monitor

Greece

		2010	2011	2012	2013	
Government Deficit Target	% of GDP	-10.6	-9.0	-5.4	-6.1	1.
BBVA Forecast				-7.5	-5.5	
Interest payment		-5.9	-7.2	-7.4	-7.4	2.
Cyclical		-0.3	-2.2	-3.9	-5.0	
Cyclically adjusted excl. Interests		-4.6	-0.1	3.8	6.8	
Structural adjustment			5.7	4.1	3.0	
General Government Debt*		148.3	170.6	175.5	185.0	3.
Central budget execution (y.t.d.)	bn €	-20.1	-12.7	up to Sep-12		4.
	% of GDP	-9.3	-6.3			

Comments

1. Greece revised its deficit targets and is asking for an extension of the program of at least 2 years as the implementation of measures are not showing the expected results. Next year target is unlikely to be met due to fiscal fatigue, the strong recession expected and the poor record in achieving fiscal targets.

2. Additional measures for €13.5bn are expected to be approved very soon.

3. Lower target for privatization revenues. Greece will aim to raise €10bn by 2016 and €25bn by 2020. The original target when the programme started in 2010 had been €50bn by 2015. The Greek government is set to guarantee the political independence of its privatization fund, TAIPED. Greece has also examined the possibility of utilizing more than 80,000 real estate properties owned by the state, which could raise €20bn to €28bn over time.

4. Greece's budget deficit for January to September narrowed sharply to €12.6bn, down from €20.1bn during the corresponding period a year earlier and below the target of €13.5bn. Revenues fell less than expected.

Portugal

		2010	2011	2012	2013	
Government Deficit Target	% of GDP	-7.3	-5.9	-4.5	-3.0	
Revised Sep-12				-5.0	-4.5	1.
BBVA Forecast				-5.0	-4.5	
Interest payment		-2.9	-4.0	-4.5	-4.7	
Cyclical		-0.5	-1.0	-1.5	-1.8	2.
Cyclically adjusted excl. Interests		-6.4	0.6	1.1	2.0	
Structural adjustment			4.7	3.5	3.2	
General Government Debt		93.5	108.1	118.8	121.4	3.
Central budget execution (y.t.d.)	bn €	-6.5	-3.9	up to Sep-12		4.
	% of GDP	-3.8	-2.4			

1. Targets were revised downwards in september after the troika 5th review. We do not foresee deviations from fiscal targets this year and next, given the scope of recently announced consolidation measures (+3.2 pp of GDP for 2013). However, measures are titled to the revenue side, implying that may have a worse than expected impact on activity.

2. Among the revenue measures announced: reduction of the number of personal income brackets (+€2.8bn) that will lead to an average higher personal income tax as well as the increase in charges over capital gains, property, house rentals, car ownership and a tax for financial transactions. Spending measures include the increase in retirement age to 65 in the public sector, cuts in temporary contracts in the public sector and lower payments for extra hours or sick leave. But the highest yielding measure will me the supresion of a monthly wage among public servants. The structural adjustment fro 2013 is estimated at 3.2 pp of GDP, to compensate for the worse macro scenario (+1.6%), higher interest rate bill (+0.1%) and the expiration of one-off measures in 2012 estimated at 1%.

3. The increase in debt is explained partly by the support to the financial sector (+4.8% of GDP) and will be partially compensated by privatization receipts (-1.7% GDP).

4. Budget execution is evolving broadly in line with targets and better than last year over the same period, but excluding the transfer from pension funds the picture is not so positive. Revenues are lagging behind as VAT collection fell, but are compensated the good performance in current spending constraints (excluding the interest rate bill, which has also been higher than expected).

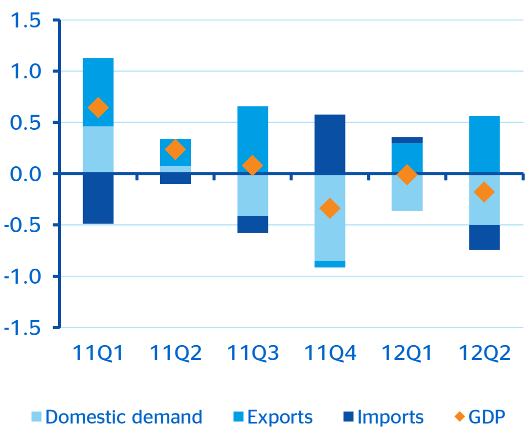
Source: Eurostat annual and quarterly financial statistics, National Stability Growth Pact documents submitted in April-May 2012, National Statistical sources and BBVA Research

4. Eurozone economic outlook

The eurozone economy contracted in the second quarter...

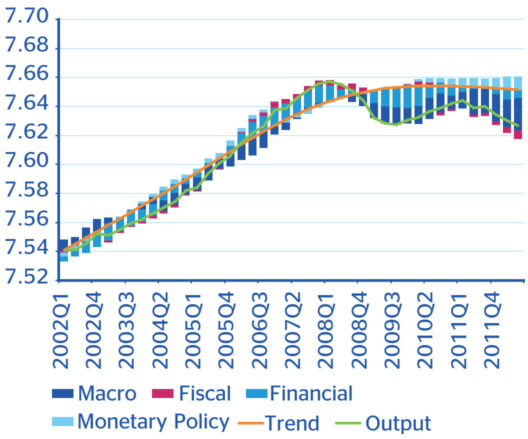
European economy relapsed as financial stress came back to markets, showing up in a drop of activity of -0.2% q/q, in line with expectations. Europe failed in seizing the window of opportunity opened by the ECB's decisions of late 2011 and early 2012, and the advances in both the fiscal pact and the ESM. The main drag on activity continued to be domestic demand (-0.5pp), while the contribution of net exports to growth declined (+0.3pp); not so much for the performance of exports - which continued to grow at a robust pace - but for a rebound in imports (Chart 6). Looking more closely at the key fundamentals underlying this performance, accommodative monetary policy provided the only support to activity, whereas the fiscal consolidation process posed a drag on growth that was not offset by an improvement in financial conditions (Chart 7).

Chart 6
EMU: GDP growth (% q/q) and contribution by components



Source: Eurostat and BBVA Research

Chart 7
Eurozone: Output, trend and shocks



Source: BBVA Research

This worsening of the crisis in the eurozone in the second quarter clearly affected all member states, albeit in different ways. Countries in the north of Europe managed to avert the recession, although growth slowed down in Germany (+0.3% q/q after +0.5% q/q in Q1) and stagnated in France. In contrast, economic activity in the periphery continued to be negatively impacted by the sharp fiscal adjustments under way and by financing problems, with GDP plummeting in Portugal (-1.2% q/q), while in Italy (-0.8% q/q) and Spain (-0.4% q/q), activity contracted at a rate similar to that earlier in the year.

...prompting a reaction from European and national authorities

The EU summit at the end of June took place in the midst of this return to recession and mounting financial stress. However, its results – steps toward a banking union, a single supervisory authority, the possibility of using the ESM to recapitalise banks and support for Spain in restructuring its banking system – failed to mitigate the re-emergence of the crisis in the eurozone. The ECB's announcement of debt purchases constituted the main positive surprise and helped to dispel fears about the euro breakup, driving to a reduction of financial stress in the third quarter, and more acutely in September. Moreover, Germany finally gave the green light for the creation of the ESM.

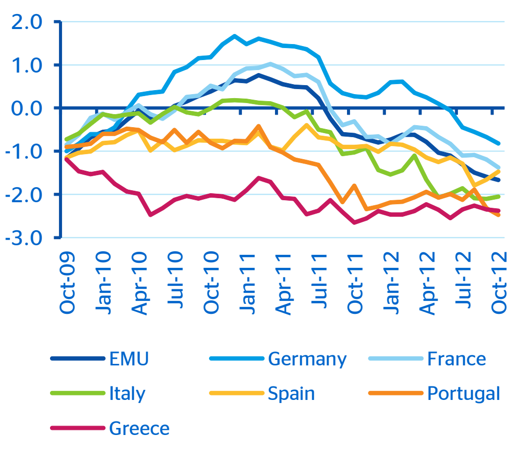
The worsening of the crisis has resulted mainly in a fall of confidence…

Nevertheless, the above is not yet reflected in economic indicators, particularly in confidence. Both the PMI survey data and those of the European Commission (EC) were disappointing for the third quarter, as they clearly remain in contractionary territory and signal that the GDP fall in the eurozone may have worsened. In spite of this, the surveys also showed certain differences: while the PMIs seem to indicate that economic activity has bottomed out, the EC surveys continue to show a clear downward trend (Chart 8).

… while hard data show a somewhat less negative outlook

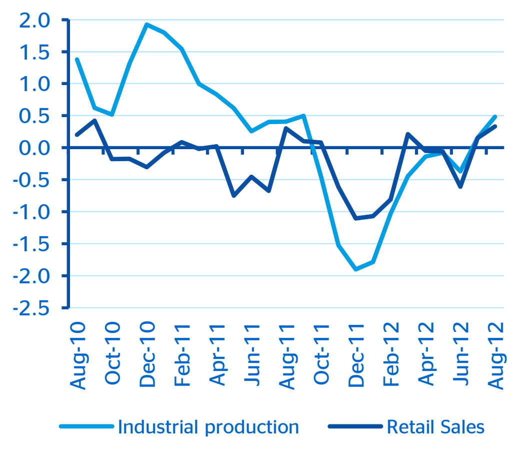
Industrial production increased both July and August, although it is still premature to confirm the recovery of this sector, especially when both domestic and external industrial orders continue to decline and, hence, do not suggest that the recovery will quickly gain traction in the coming months. In any event, the gains in production could easily be met by the present level of installed capacity, thus indicating that it is not being reflected in increased investment. Furthermore, retail sales remained practically stagnant from the end of the second quarter until August, halting the fall registered in that quarter and indicating that household spending may have been more resilient than in the previous quarter, in spite of the ongoing worsening of the labour market (unemployment increased by about 0.2pp, to 11.4%) (Chart 9).

Chart 8
EC economic sentiment (standardized)



Source: European Commission and BBVA Research

Chart 9
EMU: Hard data up to August (3-month moving average)



Source: Eurostat and BBVA Research

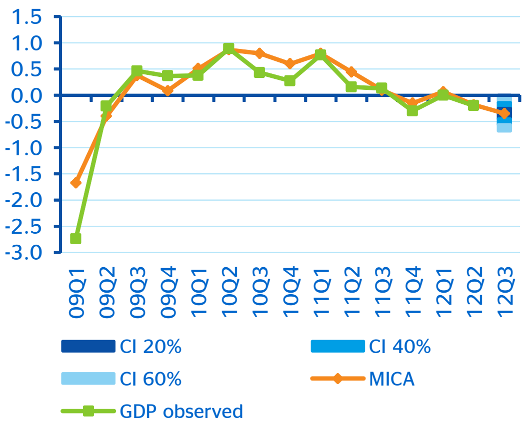
GDP could have declined further in the third quarter, dragged down by domestic demand and a smaller contribution from the external sector

Therefore, and owing to the process of fiscal adjustment under way which will take its toll on declining public consumption, domestic demand is expected to have continued to drag down economic growth in the third quarter. By countries, the divergence in domestic demand trends between the European peripheral and core countries is expected to persist, mainly as a consequence of the processes of fiscal adjustment being pursued in the former.

Consequently, the main driver of growth in the European economy will continue to be net exports. Specifically, eurozone exports grew at a robust pace up to August (1.4% q/q on Q2), while imports were somewhat more resilient (0.4% q/q on Q2) than suggested by trends in domestic demand, indicating that the positive contribution of net exports may also have decreased in the third quarter (after contributing 0.3pp in Q2). By country, the support of net exports is decisive to offset the fall of domestic demand, mainly in the peripheral countries, while the German economy continues to benefit from the still-robust growth of the emerging economies.

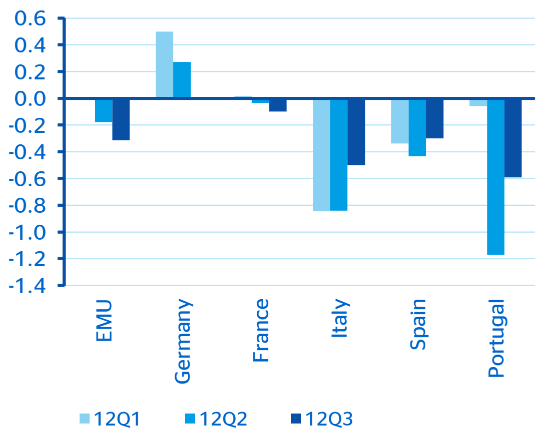
In short, taking into account these developments, our short-term model (MICA-BBVA) points to a contraction of GDP for the eurozone of 0.3% q/q in the third quarter (Chart 10). By country, our forecasts suggest that the German economy has stagnated, while the French economy has contracted by approximately -0.1% q/q. In addition, both the Spanish and Italian economy are still in recession, with the Spanish economy contracting (-0.3% q/q) at a pace similar to that of the second quarter and the decline of the Italian GDP mildly easing (-0.5% q/q) (Chart 11).

Chart 10
EMU: MICA and GDP observed (% q/q)



Source: Eurostat and BBVA Research

Chart 11
GDP growth (q/q) by countries



Source: Eurostat and BBVA Research

Although information is quite limited, recession will continue for the remainder of the year

Information available for the fourth quarter is very limited, and consists only of confidence data for October from the PMI survey and from the EC. Still, these data were worse than expected and suggest that the economy may be contracting in the last quarter of the year at a pace similar to that of the third quarter. This diminishes somewhat our expectation for a softening of the economic contraction at year end (-0.1% q/q), although it is too early to draw any firm conclusions. By country, both September and October data increased fears about whether the worst of the crisis is behind us, as the situation in the periphery appears to be significantly affecting both France and Germany, especially the former.

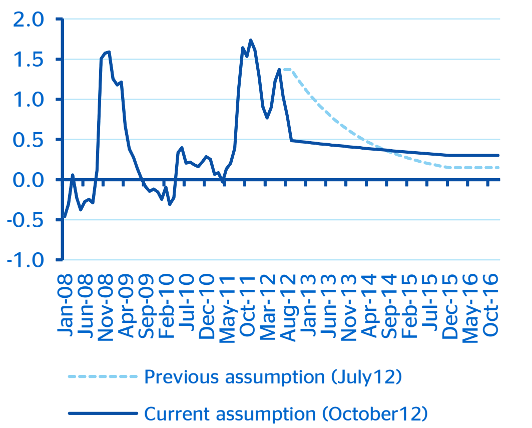
Euro break-up fears have been mostly dispelled, although growth weakness continues to shape the short term

The worsening of the crisis in the periphery prompted decisions at both European and national level, above all in peripheral countries. The ECB's announcement of its readiness to purchase sovereign debt, mainly, and the broadening of eligible collateral, constituted a positive surprise because it reduced risks of a break-up of the monetary union. The ECB plan has already been reflected in progress in easing of financial stress, and the surprise had a stronger impact than what we had assumed in our previous scenario. Hence, the decision was not only the key factor in reigning in the crisis, but it was a crucial factor in the revision of our forecasts.

Our macroeconomic scenario for both the remainder of the year and next year depends crucially on how the crisis in the eurozone is managed. Specifically, we assume there is a high probability that Spain will activate the ECB's debt purchase programme by the end of the year and that Italy may follow suit soon thereafter. Consequently, in spite of possible problems of implementation, both countries' risk premium will continue to slowly ease, as the risk of a break-up of the monetary union drastically diminishes. Nevertheless, these risk premiums may be compatible with the sustainability of public debt in the medium term without an intervention in the primary market by the ESM, which means that both countries would retain their investment grade rating. We also assume that both countries will either comply with their fiscal commitments or they will be granted an extension for attaining them. The latter may also occur in Greece, which will stay in the monetary union. Finally, we assume, first, that the recent discussion about financial supervision will not substantially affect the agreements reached in June, and secondly, that a direct recapitalisation of the banks will be allowed next year, thus breaking the vicious circle between sovereign and bank debt. Both these decisions and economic development in the third quarter have led us to revise slightly downwards our growth forecasts for this year and keep them unchanged for next year.

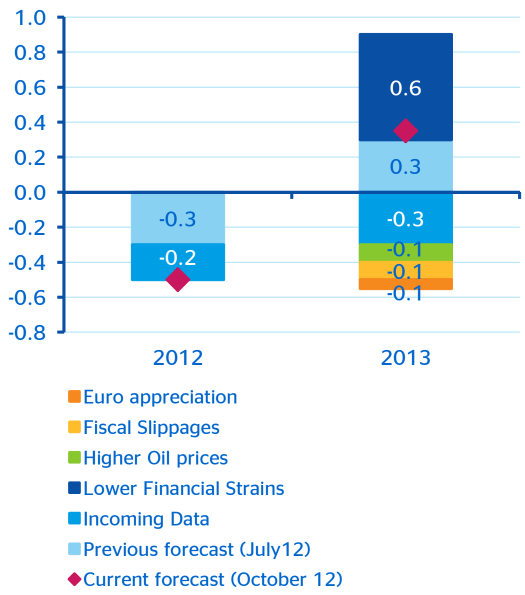
Although our previous forecasts already envisaged a continuation of elevated financial stress in the third quarter that would be similar to the second quarter, the negative impact on economic activity appears to have been greater than that estimated three months ago (as discussed above) (Chart 12). The worsening and prolongation of the expected recession for the second half of 2012 in the eurozone will have a negative impact of -0.2pp for annual average growth in 2012 and a carry-over effect of roughly -0.3pp for 2013.

Chart 12
EMU: Finalcial stress index



Source: BBVA Research

Chart 13
EMU: Annual GDP growth and factors



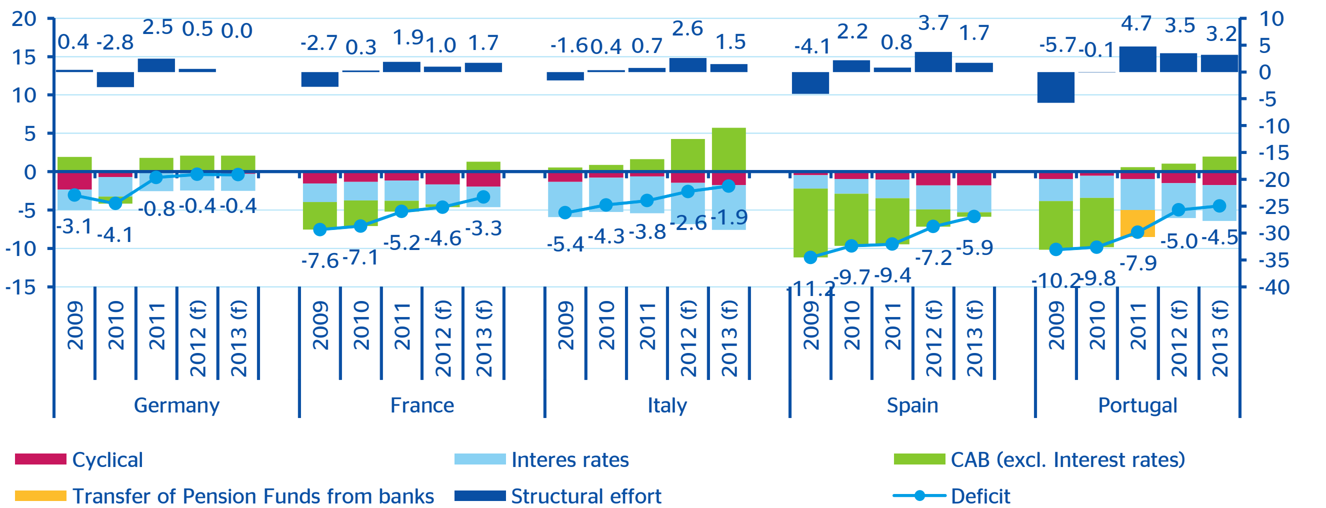
Source: BBVA Research

The main change in our assumptions relates to trends in financial stress for the coming quarters, as they are at levels lower than projected three months ago; and we expect them to continue to slowly ease throughout the forecast horizon. In accordance with our model, this new assumption would have a very limited impact on activity for the rest of 2012, but a positive impact on GDP of approximately +0.6pp in 2013 (Chart 13).

The ECB's announcement of the debt purchase programme, coupled with messages that current interest rate levels continue to be appropriate, has been reflected in an appreciation of the euro that was somewhat greater than previously anticipated. Our models estimate that this appreciation, combined with the slowdown in global demand, could result in a decline in activity of about -0.1%pp in 2013. Commodity prices, especially oil, rose again in the third quarter, in contrast with our forecast for them to fall, and now they are expected to continue to increase throughout the forecast horizon, which means that they will be about 20% higher and that, hence, they could slice another -0.1%pp from GDP growth next year.

Finally, the fiscal consolidation process will continue to weigh on growth, thus our assumptions are broadly unchanged from three months ago. Once again, national governments (mainly in the periphery and in France) have basically set forth a series of measures to be applied in order to attain the targets to which they have committed in Europe and to offset any deviations from them resulting mainly from a worsening economic outlook (Chart 14). In particular, peripheral countries have stepped up their fiscal efforts, while adjustment in others, such as Germany, should now be less than expected since they show virtually balanced budgets (Table 1). As a result, our estimates signal that new fiscal measures may have a negative impact on economic growth of about 0.1%pp in 2013.

Chart 14
General Government deficit decomposition and structural adjustement (% of GDP)



Source: Eurostat and BBVA Research

Mild recession in 2012, with a practically stagnant economy in 2013

For 2012, all the above has led to a downward revision of our previous estimate of GDP contraction in the eurozone by -0.2pp to -0.5%, which is in line with the worsening performance in economic data in the third quarter (-0.3% q/q), although this decline may have bottomed out, with a smaller contraction of economic activity in the last quarter of the year (-0.1% q/q).

For 2013, the easing of financial stress and the reduction of euro break-up fears should practically offset the negative impact of the remaining drivers of growth. Hence, we are maintaining our expectation that GDP will grow at a low 0.3% for the year overall. Still, the likelihood of recession next year remains high—about 35%.

Domestic demand will continue to drain growth, although the easing of financing costs and better confidence should mitigate the fall

The contraction of economic activity for 2012 overall will be fundamentally determined by the performance of domestic demand components (Chart 15). Private consumption will significantly contract for the year (-1%), dragged down by the fall in household disposable income since the onset of the crisis (about 2%), which is the result of both wage restraint and rising taxes and inflation.

In addition, the ongoing worsening of the labour market (nearly 4pp since mid-2008), combined with elevated uncertainty about the resolution of the European crisis, has again resulted in a decline in consumer confidence, which is only slightly higher than the record lows registered in the 2009 recession. This will lead to an increase in savings for precautionary reasons and thus a drop in spending, in spite of low interest rates. An additional factor is the need for household deleveraging, mainly in peripheral countries.

Investment will also contract significantly in 2012 (-3.6%), dragged down by the steep fall of private consumption and the slowdown of global demand. Although industrial production appears to be in the midst of an incipient recovery, excess capacity and falling corporate profits will limit any positive impact on investment. The bleak economic outlook has clearly affected companies' expectations for future demand, thus resulting in a negative contribution to inventories.

All in all, private consumption is expected to remain practically stagnant in 2013, while investment will again contract, although the pace of the downturn will ease considerably.

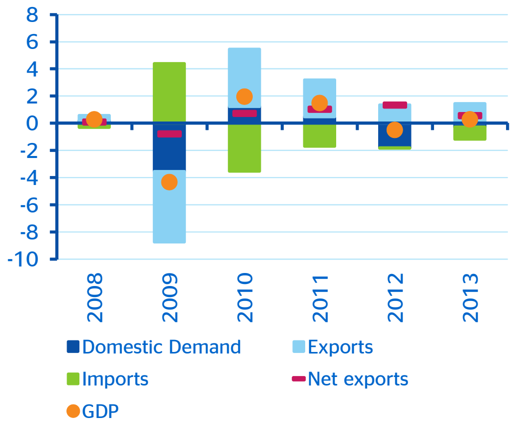
In order to ensure the sustainability of public finances, the narrow room for manoeuvre of fiscal policy will ultimately drive public consumption in a clearly pro-cyclical direction. Our forecasts estimate that public consumption will mildly contract in 2012, with the projected fall in 2013 being somewhat steeper. Hence, the public deficit in the eurozone will decrease by 0.9pp in 2012 and by 0.7pp in 2013 to -3.2% and -2.5% of GDP, respectively, with public debt increasing to 89.5% of GDP in 2012 and 90.6% in 2013.

Net exports will offset partly the fall of activity in the coming quarters

In short, exports will continue to be the main driver of growth, although they will markedly slow in 2012 as a result of lower expected growth of the global economy and a stronger euro. Although imports do not seem to have noticeably reflected the sharp contraction of domestic demand, they will be practically stagnant in 2012, leading to a strong positive contribution of net exports (+1.3pp), which will partially offset the negative contribution of domestic demand (-1.8%). In 2013, external demand will continue to make a positive contribution to growth, although a smaller one (+0.5pp), which will more than offset the negative contribution of domestic demand (-0.3pp).

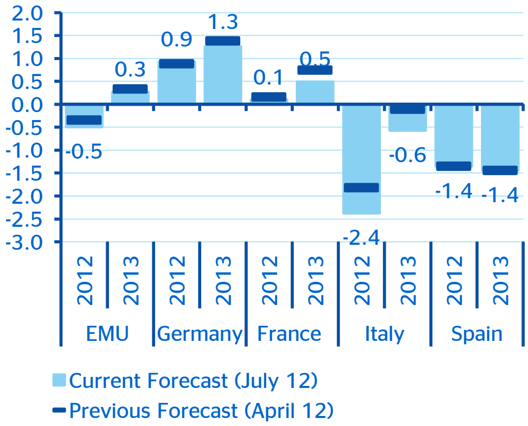
Against this backdrop, our forecasts indicate continued labour market deterioration over the coming quarters with higher job destruction (-0.8% in 2012 and -0.3% in 2013) and unemployment rising to 11.4% in 2012 and 11.8% in 2013.

Chart 15
EMU: Annual contribution to growth (pp)



Source: Eurostat and BBVA Research

Chart 16
EMU: Growth forecasts by country



Source: BBVA Research

Core countries still weak, while peripheral countries still be clearly in recession

The worsening of the European crisis in the second and third quarters was reflected in the negative impact across the whole eurozone, although there are clear differences between countries that will persist in the coming quarters. In 2012, economic growth in the countries of core Europe will significantly slow, but they will register positive growth rates (Germany with 0.9%, mainly, and France with a meagre 0.1%), while periphery countries will see significant falls in GDP (Italy will drop by -2.4%, Spain by -1.4% and Portugal by -2.8%) (Chart 16). This divergence is due mainly to the processes of macroeconomic adjustment that will take place in the peripheral countries and which will substantially affect components of domestic demand. Net exports, instead, will provide across-the-board support in all member states.

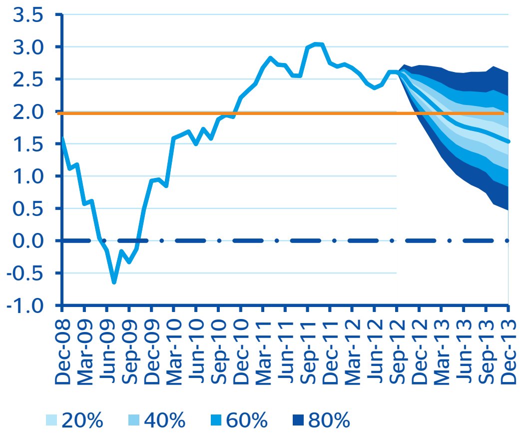
In sum, the incipient recovery forecast for the eurozone in 2013 will not be widespread. Despite attempts to solve institutional problems at a Europe-wide level, peripheral countries must continue to correct accumulated economic imbalances. For this reason, our forecasts envisage a certain consolidation of the recovery, albeit slow, in countries of central and northern Europe (Germany: 1.3% and France: 0.5%), while the countries of the periphery will remain in recession (Italy: -0.6%, Spain: -1.4% and Portugal: -0.7%) (Chart 16).

Inflation will remain at about 2.4% for the rest of the year…

Inflation in the eurozone increased somewhat more than expected in the third quarter, driven by oil prices that were higher than anticipated three months ago and by tax hikes. In particular, following the rise in August (+0.2pp), inflation remained stable at 2.6% y/y in September, given that the higher inflation in the most volatile components was offset by a drop in core inflation (by -0.1pp to 1.6% y/y). Energy prices fully account for the upside surprise on our expectation for the third quarter overall a whole, whereas core inflation remained stable at 1.8%, as expected. In short, high inflation at present is driven mainly by stronger energy inflation, which accounts for about 40% (Chart 18).

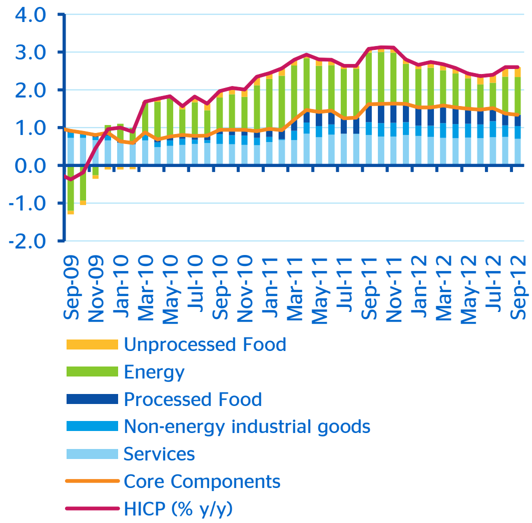
Nevertheless, data up to September show no evidence of any second-round effects, while the decline in domestic demand and the gloomy economic outlook for the coming quarters should prevent such effects from materialising in either the short or medium term. For the remainder of the year, we expect inflation to slow down in October, fluctuating at about 2.4% y/y in the fourth quarter, while core inflation will remain stable at 1.6% y/y. As a result, annual average inflation in 2012 will end up at 2.5% (+0.2pp above our previous estimate) and core inflation at 1.8% (Chart 17).

Chart 17
EMU: Inflation (% y/y)



Source: Eurostat and BBVA Researc

Chart 18
EMU: Annual HICP Inflation Rate: Contributions by Component



Source: Eurostat and BBVA Researc

… but it will slow down throughout 2013 across all member states

Although we revised our inflation outlook slightly upwards, our models indicate that inflation will continue to decelerate next year, with headline inflation below the ECB's target at midyear. Consequently, we now expect an annual average inflation rate of 1.8% in 2013, which represents an upward revision of +0.4pp on our previous forecast. Of this rise, +0.3pp is due to higher commodity prices and the remaining +0.1pp to the tax hike, which accounts for the rise in our expected core inflation rate from 1.4% to 1.5%.

By country, there are also significant differences in inflation, which was slightly above 2% y/y in France and Germany in September, while in Spain and Italy it rose to about 3.5%. Behind these significant differences mainly lie tax hikes and/or administered prices linked to the fiscal consolidation being implemented in these countries. In any case, as these taxes are temporary, the projected deceleration of inflation in the eurozone in 2013 will occur across all member states.

Risks to economic activity still tilted to the downside

Thanks to the ECB announcement of the availability of the OMT programme, the likelihood of a financial accident has dramatically diminished, particularly since the risk of a euro break-up, as perceived by markets, has significantly reduced. Thus, the probability of a risk scenario, with a deep recession in Europe, has greatly decreased. However, our projections are still tilted downwards. Specifically, downside risks to our growth scenario stem from a poor implementation of economic policy measures announced by European authorities and national governments.

First, there are risks that sovereign bond spreads jump back for periphery countries if Spain and Italy still decide to postpone the request for assistance to the ESM, and, by extension, to the ECB; or that there are delays in the provision of funds from the core eurozone. In addition, even if these countries do ask for the assistance to be activated, serious problems may arise if they should ever fail to comply with the accepted conditionality, as the ECB has revealed that non-compliance would involve the withdrawal of the programme. Although it is not certain that such conditionality would be strictly applied, we cannot rule this possibility out.

Moreover, the problem of Greece has yet to be solved, and it could resurface as past episodes of non-compliance with reforms or economic results below expectations could take place again.

There are also downside risks from outside of the eurozone, like the materialisation of downside risks related to fiscal problems (i.e. the "fiscal cliff") in the US. Neither a larger-than-expected deceleration of emerging economies could be ruled out.

The risks in our inflation scenario are balanced. There are upside risks stemming from possible tax hikes as part of the fiscal consolidation under way and from sharper increases in commodity prices (food and energy). Nonetheless, this is offset by the downside risks that could arise from a further slowdown in economic activity.

Eurozone member states: detailed analysis

Eurozone:
The recession will continue into the second half of the year, with the economy at a near standstill in 2013

GDP: -0.5% in 2012 +0.3% in 2013 HICP: +2.5% in 2012 +1.8% in 2013

Latest official data for Q2 12: European economy relapsed as financial stress came back to markets, showing up in a drop of activity of -0.2% q/q, in line with expectations. The main drag on activity continued to be domestic demand (-0.5pp), while the contribution of net exports to growth declined (+0.3pp); not so much for the performance of exports - which continued to grow at a robust pace - but for a rebound in imports.

Incoming data for Q3 and Q4: The worsening of the crisis has resulted mainly in a fall of confidence. Both the PMI survey data and those of the European Commission (EC) were disappointing for the third quarter, as they clearly remain in contractionary territory and signal that the GDP fall in the eurozone may have worsened. Nevertheless, hard data point to a somewhat less negative outlook. Industrial production increased in July and August, although it is still premature to confirm the recovery of this sector, especially when both domestic and external industrial orders continue to decline and, hence, do not suggest that the recovery will quickly gain traction in the coming months. In any event, the gains in production could easily be met by the present level of installed capacity, thus indicating that it is not being reflected in increased investment. Furthermore, retail sales remained practically stagnant from the end of the second quarter until August, halting the fall registered in that quarter and indicating that household spending may have been more resilient than in the previous quarter, in spite of the ongoing worsening of the labour market. Therefore, and owing to the process of fiscal adjustment under way which will take its toll on declining public consumption, domestic demand is expected to have continued to drag down economic growth in the third quarter. The main driver of growth in the eurozone economy will, then, continue to be net exports. Specifically, exports grew at a robust pace through August, although imports were somewhat more resilient than suggested by the performance of domestic demand. Hence, the positive contribution of net exports may also have decreased in the third quarter. Overall, our short-term MICA-BBVA model points to a contraction of GDP for the Eurozone of -0.3% q/q in Q3. Information available for Q4 is very limited, and consists only of confidence data both from the PMI survey and from the EC for October. Still, these data were worse than expected, suggesting that the pace of economic contraction in the last part of the year may be similar to that of the third quarter. This diminishes somewhat our expectation that the economic contraction would ease at year end (-0.1% q/q), although it is too early to draw any firm conclusions.

Outlook for 2012 and 2013: The contraction of economic activity for 2012 overall will be fundamentally determined by the performance of domestic demand , with the latter continuing to act as a drag on growth, although the relaxation of financing costs following the ECB's announcement and the improve in confidence should mitigate its fall. In addition, net exports should continue to soften the downturn in activity in coming quarters. In sum, the less favourable economic data for Q3 lead us to revise downward our growth forecast for 2012 by -0.2pp to -0.5%. For 2013, the easing of financial stress and the lessening of euro break-up fears should practically offset the worsening performance of the remaining drivers of growth. We are therefore maintaining our projection that GDP growth will stand at a meagre +0.3% for the year overall. Nevertheless, the likelihood of recession next year remains high—about 35%.

Inflation outlook: Inflation increased somewhat more than expected in Q3, driven by oil prices that were higher than projected three months ago as well as tax hikes. In particular, following the rise posted in August (+0.2pp), inflation remained stable at 2.6% y/y in September, given that the higher inflation in the most volatile components was offset by a drop in core inflation (by -0.1pp to 1.6% y/y). Energy prices fully account for the surprising rise, above our expectations, for the third quarter overall, whereas core inflation remained stable at 1.8%, as expected. In the remainder of the year, we expect inflation to fall in October, in line with the flash estimate, and to hover at about 2.4% y/y in the final quarter of the year, and core inflation to remain stable at 1.6% y/y. Average annual inflation in 2012 should therefore stand at 2.5% (+0.2pp above our previous estimate) and core inflation at 1.8%. Although we revised our inflation outlook slightly upward, our models indicate that inflation will continue to slow next year, with headline inflation projected to be below the ECB's target at midyear. We now expect an annual average inflation rate of 1.8% in 2013, which represents an upward revision of +0.4pp from our previous forecast. Of this increase, +0.3pp is due to higher prices for raw materials and the remaining +0.1pp to the tax hike, which accounts for the rise in our expected core inflation rate from 1.4% to 1.5%.

Germany: Domestic demand will continue to underpin economic growth

GDP: +0.9% in 2012	+1.3% in 2013	HICP: +2.1% in 2012	+1.8% in 2013

Latest official data for Q2 12: GDP growth slipped by 0.2pp to 0.3% q/q, owing mainly to the smaller contribution of net exports (0.3pp compared with 0.5pp in Q1), although the decline was partially offset by a lesser drag from domestic demand (-0.1pp compared with -0.2pp in Q1). Nevertheless, domestic demand was driven mainly by the continued improvement in private consumption as a result of its stronger fundamentals and by the fact that public consumption grew once again at a stable, moderate rate, given that investment dropped for the second consecutive quarter (by about -1% q/q in both quarters), pulled down especially by investment in capital goods.

Incoming data for Q3 and Q4: Confidence indicators for Q3 as a whole point to a further deterioration following a worsening in Q2. This indicates a likely continuation in the slowdown, and possibly even a contraction, in economic activity, as suggested by the drop in PMIs to well below 50 points mainly as a result of the drag from the industrial sector, whereas the figure for services was likely more consistent with stagnation. The figures for September, however, improved, partially offsetting the decline in previous months. In general, data from the remaining surveys (EC, ZEW and Ifo) point in the same direction and are in fact even more pessimistic, given that they do not yet provide signs of stabilisation and expectations for the coming quarters worsened once again. The hard indicators give mixed signals. On the one hand, industrial output up to August is expected to have risen by 1.5% over Q2, when growth was practically stagnant, although given the recent fall in capacity utilization this increase is not likely to be reflected in a significant improvement in investment. However, retail sales have fallen by a cumulative 1% through August compared with Q2, suggesting that private consumption may have slackened in the third quarter, in part owing to lower consumer confidence as a result of the worsening crisis in the peripheral countries. Lastly, foreign trade figures indicate that export growth remains robust, although imports are increasing at a faster pace as a result of resilient domestic demand, which might be reflected once again in a weaker boost from net exports in Q3. In sum, our forecasts point to economic stagnation. For Q4, the only available data are those from October surveys; however, these data project continued economic sluggishness for the remainder of the year.

Outlook for 2012 and 2013: While the German economy is not immune from the crisis in the peripheral countries, economic growth drivers remain robust and therefore will continue to buoy the economy throughout the forecast horizon. The ongoing improvement in the labour market should redound in improved consumer confidence once the European crisis wanes. Together with the increase in households' disposable income, which did not experience significant imbalances, this should translate into higher private consumption in both 2012 and 2013. The rapid rebalancing of public accounts should, in addition, allow for a neutral fiscal policy both this year and next. Moreover, still-robust growth in emerging economies is expected to continue to bolster exports, although the latter will increase at a significant lower rate than in previous years. Given the significant reduction in capacity utilization in the second half of this year, projected demand, both domestic and external, can be met with no need for further investment during the rest of the year, and investment will also be dragged down by the highly uncertain European outlook. Investment is therefore expected to contract sharply in 2012 before returning to growth in 2013. Lastly, the counterpart of strong domestic demand will be higher imports, leading, therefore, to a gradual reduction in the contribution of net exports, especially in 2013. In sum, we are maintaining our growth forecasts, and expect German GDP to grow by 0.9% in 2012 before inching up to 1.3% in 2013.

Inflation outlook: The third quarter spike in energy prices marked the end of the gradual deceleration in headline inflation seen in the previous quarter, as the rate stood at 2.1% y/y in September. Nevertheless, core inflation has dropped sharply, to 1.2% y/y. As in the eurozone, in Germany, the uptick in energy prices has led us to raise our forecasts slightly and we now project an annual average inflation rate of 2.1% in 2012 and 1.8% in 2013.

Public sector: Data for September continue to point to a strong budget outturn. Fiscal revenue has risen 4.2% from the previous year, reflecting the healthy labour market and robust consumption. Although the authorities expect a slowdown in the increase in revenue collection in coming months, this year's target (revised upward to -0.5% of GDP) should easily be met. The debt is expected to increase by 2.5pp of GDP from the 80.5% posted in 2011 as a result of the inclusion of contributions to the bailout funds.

France: Weak domestic demand will be reflected in a slower recovery in 2013

GDP: +0.1% in 2012 +0.5% in 2013 HICO: +2.3% in 2012 +1.7% in 2013

Latest official data for Q2 12: The economy remained stagnant for the third consecutive quarter, as external demand continued to act as a drag on growth while domestic demand exerted a countervailing effect. Nevertheless, domestic demand showed more worrying signs, inasmuch as it depended mainly on growth in public consumption and the contribution of inventories, while private consumption contracted slightly and the rebound in investment proved insufficient to offset the sharp downturn posted in the previous quarter.

Incoming data for Q3 and Q4: Although confidence remained relatively stable at the beginning of Q3, especially in comparison with other member states, it plummeted sharply, and more than expected, in September, suggesting that the economy may have contracted in the quarter. In addition, this worsening was generalized across sectors, and was reflected in every survey. As was noted for the eurozone as a whole, the hard data do not reflect such a severe economic downturn. Industrial production rebounded in July and especially in August, although this upturn was driven by a particularly volatile component—transport—while lower industrial confidence and orders do not portend an imminent recovery. Retail sales also rose more than expected in July, although this increase was partially diluted by data for August, while consumer spending increased timidly. These data do not, however, point to a new contraction in private consumption in Q3; hence, private consumption may have remained stagnant, partially as a result of the continuing deterioration of the jobs market (+0.4pp to 10.8%). Foreign trade has had a somewhat more favourable performance, as exports rose at a faster rate than in the previous quarter, while imports appear to have been harmed by weak domestic demand. This may translate into a less negative contribution of net exports. We estimate, nonetheless, that GDP fell by -0.1% q/q in the third quarter. Equally worrying are the data for October, which suggest that economic activity may have contracted once again, although CE indicators and PMIs are giving mixed signals, as the former deteriorated further and the latter recovered slightly, although clearly by less than 50 points.

Outlook for 2012 and 2013: One of the main changes from our forecasts three months ago is that we now expect a worsening of some of the drivers of domestic demand, including a significant deterioration of the labour market throughout the year and a sharp drop in confidence, particularly among consumers. This comes on top of the tax hike announced for next year and the elimination of some deductions. All of this will translate into a fall in disposable household income. The need to put public accounts in order indicates that the driver of public consumption will fade for the rest of this year and especially next year. We thus expect private consumption to be flat or even to contract slightly this year and to grow very slightly in 2013, with public consumption also remaining flat after growing 0.8% in 2012. Investment proved somewhat more resilient than in other countries in the area, although growth for this year and next will be very modest, as it will be hampered by the fall in corporate earnings and worse expectations for future demand. This could also be reflected in a significant diminishment in inventories, following the considerable restocking last year. Lastly, as has been the case in previous years, the French economy has benefited less from growth in global demand, and any benefit was partially offset by the surge in imports driven by higher domestic spending. Nevertheless, net exports are expected to add 0.4pp to GDP growth this year and 0.1pp in 2013, compensating for the -0.3pp contribution of domestic demand in 2012, in addition to the projected 0.4pp contribution in 2013. As a result, although we continue to expect GDP to have been practically stagnant this year (0.1%), we have revised our 2013 forecast slightly downward, by -0.3pp to 0.5%.

Inflation outlook: Unlike in the eurozone as a whole, French inflation remained stable in Q3 at 2.3% y/y, in line with expectations, while core inflation dropped by -0.1pp to 1.8% y/y. The main reason for this is the French economy's lower degree of energy dependence. In coming months, inflation should continue to gradually decline, resulting in an annual average inflation rate of 2.3% in 2012, in line with our previous forecast; still, we have adjusted our forecast slightly upward, albeit less than for the rest of the Eurozone—to 1.7% for 2013—owing to our current projection of higher raw materials prices.

Public sector: The details of the adjustment measures were presented on 28 September. The government has committed to reduce the structural deficit to 0% in 2016; in the shorter term, the deficit is expected to fall from 4.5% of GDP in 2012 to 3% next year, translating into a structural adjustment of 2% of GDP. The measures announced and detailed amount to €30Bn (1.5% of GDP), divided equally among households, large companies and government. In this first year, the adjustment is weighted toward a tax increase on the highest incomes, and the plan calls for gradually changing the composition of the adjustment towards a larger expenditure cut. Large companies will be allowed to take fewer deductions and will be required to pay higher income tax. In addition, the highest income earners will pay 4pp more in income tax, which will rise to 45% on those grossing more than €150,000 per year and to 75% for those grossing more than €1Mn. Given the optimism of the macro forecasts—the government estimates that the economy will grow by 0.8% in 2013 (BBVA: 0.5%)—and the risk that the measures will fail to have the desired impact in terms of either revenue collection or expenditure reduction, additional measures are likely to be needed. Regarding institutional matters, the Fiscal Compact was passed by parliament.

Italy: The recession intensifies and will linger into 2013

GDP: -2.4% in 2012	-0.6% in 2013	HICP: +3.4% in 2012	+2.3% in 2013

Latest official data for Q2 12: Economic performance has been clearly marked by the resurgence of the debt crisis in the peripheral countries. Economic activity contracted for the third consecutive quarter (-0.8% y/y), dragged down fundamentally by domestic demand, which drained 1pp of GDP. In Italy, unlike in other non-core economies, exports have fallen sharply and have played a less decisive role in offsetting flagging domestic demand; nonetheless, owing to the sharp drop in imports, net exports softened somewhat the downturn in economic activity, adding +0.2pp to GDP.

Incoming data for Q3 and Q4: Confidence indicators for Q3 overall suggest that the economy contracted once again, although the decline was more moderate than in the three previous quarters. The available hard data up to August point in the same direction. The drop in industrial output appears to have been halted, following the sharp contraction seen over the last year, although the rebound in August may have been associated with seasonal factors. Confidence indicators give no hint that the recovery will be sustained. Retail sales remain very sluggish; the continued worsening of the labour market, higher taxes and the still-high inflation rate could have continued taking their toll on household expenditure. Public consumption is likely to continue to fall as a result of the strong fiscal adjustment under way, while the sharp drop in private sector expenditure is expected to continue to curb investment. Regarding foreign demand, exports appear to have improved somewhat although imports proved more resilient; as a result, the boost from net exports may have weakened. All in all, our forecasts point to a -0.5% y/y decline in GDP in the Q3. For Q4, confidence data for October suggest that the recession may once again ease in the home stretch of the year.

Outlook for 2012 and 2013: The worsening economic performance in the first half of the year along with the sharp increase in financial stress that continued for much of the third quarter and the government's new measures for meeting its fiscal commitments have led us to revise our growth forecasts downward for both 2012 and 2013. We now expect a stronger contraction of GDP (-0.6pp more than previously forecast, to -2.4%) in 2012, as a result of the plummeting of all components of domestic demand (-4.7pp), which will not be offset by a substantial improvement in net exports (+2.3pp). In 2013, the ongoing fiscal adjustment, the as-yet high cost of financing, continued tight credit conditions and the worsening labour market will continue to weigh heavily on the Italian economy. Nevertheless, our forecasts now point to an incipient recovery at the end of next year, notwithstanding which GDP is expected to contract by -0.6% in 2013.

Inflation outlook: Inflation slipped in Q3 by about -0.2pp to 3.4% y/y due to the depletion of the VAT increase in September 2011, although this effect was partly offset by higher prices of raw materials. Core inflation also fell to 2.4% y/y from 2.6% y/y in the second quarter. Because of the sharp increase in raw materials prices, we have revised our annual average inflation forecast for 2012 upward slightly, by +0.1pp, to 3.4%, as well as that for 2013, by +0.4pp, to 2.3%. Our forecast therefore remains above our forecast for the eurozone as a whole, as a result of the VAT hike scheduled for July of next year.

Public sector: Budget outturn data for the central government through October point to a noteworthy improvement from the previous year; thanks to the downward revision of the target from -1.7% to -2.6% of GDP, the government should easily reach that target. Monti's government has submitted to parliament the details of its 2013 budget, in order to reach the new target of -1.7%. The spending measures include greater control over the provision of subsidies, curtailments in health expenditures and a freeze on public sector wages. In addition, no real estate acquisitions will be made and no vehicles will be purchased or leased, IT consulting will be limited and steps will be taken to ensure greater efficiency in electricity expenditures. Transfers to autonomous regions will be slashed by €1bn. Regarding the revenue measures, the income tax on persons grossing less than €28,000 a year will be reduced. Despite what had been announced previously, the VAT rate will rise by only 1pp starting in July, with the general rate going up from 21% to 22% and the reduced rate increasing to 11%. The government has also shown its firm commitment to reaching a structural primary surplus in keeping with the implementation of the fiscal rule, which will take effect in 2014.

Portugal: The ongoing adjustments will result in a deeper recession in 2013

GDP: -2.8% in 2012	-0.7% in 2013	HICP: +2.9% in 2012	+1.2% in 2013

Latest official data for Q2 12: The current fiscal adjustment, in addition to the deleveraging of the private sector, waning confidence and a worsening labour market, were all behind the larger drop in domestic demand (-2.7pp vs. -0.1pp in Q1). However, the drop in private (-0.8% q/q) and public (-0.1% q/q) was less severe than in the first quarter, although investment (-19.3% q/q) plunged much more than expected. While net exports' contribution to GDP increased (+1.5pp), Q2 data were slightly less optimistic as exports grew by only 0.7% q/q, indicating that the positive contribution was due mainly to the sharp fall in imports (-3.3% q/q).

Incoming data for Q3 and Q4: Despite the resurgence of the crisis in other peripheral countries and the additional adjustments announced by the government, confidence remained relatively stable throughout Q3. Still, it was very low and worsened sharply in September. Nevertheless, activity figures offer a somewhat less bleak outlook, with industrial production rebounding by 2.3% q/q, despite the sharp drop observed in September, while retail sales also gained 1.5% q/q. Although this performance is likely transitory and domestic demand factors are quite fragile, the data indicate that it may have been less of a drag on activity than in Q2. In addition, external sector data to September continue to show robust export growth, but also somewhat more resilient imports. Hence, the positive contribution of net exports may have diminished. All in all, our MICA-BBVA model estimates that the pace of economic slowdown should ease in Q3 (-0.5% q/q). For Q4, EC confidence figures for October—the only figures currently available—signal that the economy will continue to contract, with no signs of stabilisation, which would point to downside risks in our forecasts.

Outlook for 2012 and 2013: Short-term estimates are in line with our macro-economic scenario, which project a -2.8% GDP contraction in 2012 (somewhat more optimistic than the -3% projected in the troika's latest report and previous estimates). For 2013, we have revised downward our projections from -0.4% to -0.7% owing to the impact of the new fiscal measures recently announced and to possible negative spillovers from the Spanish economy and the global environment—although the economy could also benefit from a better climate in the financial markets and lessened tensions due to the measures recently announced by the ECB. According to our forecasts, domestic demand will continue to contribute negatively to growth, with a sharp decline in private and public consumption, although this fall is expected to ease in 2013. The largest decline will occur in investment, both this year and next. By contrast, net exports are expected to continue making a positive contribution, albeit at a slower pace in both years.

Inflation outlook: Tax hikes in recent years have not only negatively affected household disposable incomes, but have also kept inflation at rates higher than expected, considering the current economic contraction and, especially, plummeting domestic demand. In addition, the recent increases in raw materials prices halted the slowdown in inflation seen in the first part of the year as a result of the tapering off of the effect of the tax hikes the year before. Hence, there was a slight +0.2pp rise in inflation in Q3, to 3.0% y/y, while core inflation continued to fall sharply, to 1.4% y/y. We thus now expect an annual average inflation rate of 2.9% in 2012, +0.2pp higher than our previous estimate, although we continue to project a significant slowdown in 2013, resulting in an annual average inflation rate of 1.2%.

Public sector: In mid-October, following approval by the troika of the sixth tranche of assistance, the government announced the details of its 2013 budget aimed at attaining the new deficit target of 4.5% of GDP. The measures amount to €5.3bn (3.2% of GDP). This amount is earmarked to cover the following: (a) a deficit reduction of 0.5pp between 2012 and 2013; (b) offsetting some of the temporary measures implemented in 2012, which are equivalent to 1% of GDP; (c) an expected increase in the interest payment (0.1pp) and (d) the worsening of the macro-economic scenario (1.6pp of GDP). In general, it appears that the 2013 budget is sufficient to attain the targets, although it is very weighted towards greater tax revenue.

Spain: The economy will remain in recession through 2013

GDP:-1.4% in 2012	-1.4% in 2013	HICP: +2.5% in 2012	+2.3% in 2013

Latest official data for Q2 12: The Spanish economy contracted by -0.4% q/q, in line with expectations, and the composition of economic growth changed little. The performance of the economy was once again marked by rising net exports, which added 0.9pp to GDP; while domestic demand continued to pull down growth (-1.4pp).

Incoming data for Q3 and Q4: Though final breakdowns are still out, preliminary GDP forecasts released by the National Statistics Institute indicate that the economy contracted -0.3% q/q in Q3, for the fourth straight quarter of decline. Preliminary economic indicators published to date indicate that most of the components of domestic demand continued to contract, subtracting -1.1pp from GDP overall. It is likely that the composition of growth once again featured an increase in net exports, and this probably contributed 0.7pp to GDP, as a result of sharply higher sales abroad and despite the rise in imports. For Q4, the drivers of growth remain quite weak, pointing to a continued economic downturn.

Outlook for 2012 and 2013: Despite the progress in structural reform both in Europe and in Spain, the drivers of economic performance remain consistent with an economic contraction of about -1.4% in both 2012 and 2013. We are thus standing by our previous forecasts. In particular, we expect that the economic impact of both the higher inflationary pressure of oil prices and the downward revision of the growth outlook for the eurozone will be offset by a lower risk premium than we expected three months ago. In terms of components, the growth in external demand, although noteworthy, will be insufficient to compensate for lower domestic demand in the forecast horizon. In this scenario, employment figures look set to fall further in the fourth quarter of 2012 and in 2013 overall, causing the unemployment rate to rise to around 26% at the end of the year despite the expected reduction in the size of the active population.

Inflation outlook: In Q3, both headline and underlying inflation rose sharply, to 3.4% y/y and 2.1% y/y, in September. These figures are the result of factors exogenous to demand, such as the upward pressure on raw materials prices, the increase in drug co-payments starting in July and the VAT hike in September, rather than inflationary pressure on domestic market. The annual average inflation rate is consequently expected to stand at 2.5% in 2012, while the tax increases along with the higher prices for raw materials will mean that inflation will slow only slightly in 2013, to 2.3%, and thus remain above the eurozone average.

Public sector: The results of the government's consolidation policy have been somewhat modest in the first half of the year, with it still needing more than 2.5pp in adjustments to meet its target of a deficit equivalent to -6.3% of GDP by the end of the year. Although the adjustment is likely to intensify during the second half of the year—when a large part of the announced measures take effect (VAT hike, elimination of extra payment at Christmas or some measures contained in the economic-financial plans of the regions)—this will probably be insufficient to make up for the negative effects of the downturn in GDP on revenue and spending. Nevertheless, excluding financial assistance for the banking sector, the deficit of the public administrations is expected to stand at about -7.2% of GDP at year-end, and therefore to be above the target. The size of this deviation means that the 2013 target is less likely to be met. It will be necessary to reduce the deficit by 2.7pp of GDP next year, in addition addressing the effect of the economic downturn-which is projected to stand at above -0.8pp of GDP. Reach the deficit target by the end of 2013 would require fiscal adjustment measures equivalent to about 3.5pp of GDP, of which an amount equivalent to 2.3pp has been announced. Thus, without additional measures, the deficit in 2013 will be about 1.5pp above the target (-4.5% of GDP).

Box 1. Portugal: The ongoing adjustments will result in a deeper recession in 2013

Available data for Q3 indicate that the pace of the slowdown in activity is easing (-0.6 q/q), following the sharp contraction in Q2 (-1.2% q/q). The external sector continues to be the main support, as exports are still showing robust growth in spite of the deceleration of global demand, and imports are losing substantial ground owing to the weakness of domestic demand. For the year, we forecast a GDP fall of -2.8%, which is somewhat more moderate than the forecast of the government and the troika. For 2013, we have revised our forecast downwards, and we expect a contraction of -0.7%, instead of our previous -0.3%, owing to the new fiscal adjustment measures announced - which are heavily weighted towards tax increases -, a sharp downturn in the labour market, lower consumer confidence and slower global growth. Nevertheless, the ECB OMT programme should bring a further reduction in financing costs, with consequences not so much for the bailed-out public sector, but rather for the private sector, which could benefit from a more positive general mood in the financial markets of the peripheral countries.

The troika has given the green light to the sixth tranche of assistance and loosened the budget deficit targets for the next two years, thus allowing more time for the adjustment. The Portuguese government submitted its 2013 budget, adapted to the new targets, but it has nevertheless announced further measures to counteract the fall in economic activity, the larger interest payments and the expiry of some of the 2012 measures. Finally, the calendar for Portugal's return to the market from mid-2013 is being maintained. The better mood in the financial markets following the ECB's announcement now makes this objective more plausible than three months ago.

GDP will contract by roughly -1.2% q/q in 2Q12, in line with expectations, dragged down by the sharp fall in domestic demand

The current fiscal adjustment, in addition to the deleveraging of the private sector, the decline in confidence and a worsening labour market, are all behind the larger decline in domestic demand (-2.7pp vs. -0.1pp in Q1). However, the drop in private (-0.8% q/q) and public consumption (-0.1% q/q) was lower than the one in the first quarter, although investment (-10.3% q/q) showed a greater than expected slump. While the contribution of net exports to GDP increased (+1.5pp), Q2 data were slightly less optimistic as exports grew by only 0.7% q/q, implying that the positive contribution owed mainly to the sharp decline in imports (-3.3% q/q).

Available Q3 data suggest that the slowdown is easing

In spite of the resurgence of the crisis in other peripheral countries and the additional adjustments announced in Portugal, confidence remained relatively stable throughout the quarter, albeit at very low levels and sharply worsening in September. Nevertheless, activity data offer a somewhat less bleak outlook, with industrial production rebounding by 2.3% q/q over the quarter, despite the sharp drop observed in September, while retail sales also gained 1.5% q/q. Although this performance is likely transitory and domestic demand factors are quite fragile, the data indicate that it may have been less of a drag on activity than in Q2.

For Q4, only EC confidence figures for October are available, which signal that the economy will continue to contract, with no signs of stabilisation, which would imply downside risks in our forecasts. Finally, external sector data to September continues to show robust growth of exports, but also somewhat more resilient imports. Hence, the positive contribution of net exports may have diminished.

External demand support is showing signs of exhaustion from strong start-of-year levels

External sector data for September show that, even though exports continue to decelerate, they are still growing at a healthy pace, while imports have been somewhat more resilient, but still weak. Therefore, we expect the external sector to continue to support growth while at the same time allowing the external sector deficit to be rapidly corrected. Specifically, the 12-month cumulative balance of trade deficit to August stood at €-4.3bn, or the equivalent of 2.6% of GDP. The correction has been substantial, from a peak of -12.8% in January 2009, and it has accelerated in recent months, due mainly to the improved balance of goods, where exports remaining on a healthy growth path owing to exports to emerging markets. However, the slowdown in imports initiated in the second quarter of 2011 has eased. The balance of services also remains healthy although service exports are showing signs of moderation.

Our MICA-BBVA model points to further contraction of GDP in Q3

On the basis of the partial information now available on the third quarter of the year, particularly confidence indicators, we anticipate a GDP fall of -0.5% q/q in 3Q.

The outlook for 2012 remains unchanged, but worsens slightly for 2013

Short-term estimates are in line with our macro-economic scenario, which anticipates a GDP contraction of -2.8% in 2012 (somewhat more optimistic than the -3% projected in the troika's latest report and previous estimates). For 2013, we have revised downward our projections from -0.3% to -0.7% owing to the impact of the new fiscal measures recently announced and to a possible negative knock-on effect of the Spanish economy and the global environment; although it could also benefit from a better climate in the financial markets and lessened tensions due to the measures recently announced by the ECB.

According to our forecasts, domestic demand will continue to contribute negatively to growth (-5.4pp in 2012), with a sharp decline in private and public consumption, although this fall is expected to ease in 2013. The largest decline will occur in investment, both this year and next. On the other hand, net exports are expected to continue making a positive contribution, albeit at a slower pace in both years.

The outlook for consumption continues to be negative, even though it is in line with the necessary deleveraging of households (we should recall that Portugal's elevated external trade imbalance in the past decade was largely accounted for by a very high rate of consumption). The labour market is still in a difficult process of adjustment, with unemployment gradually rising (+1.4pp year to date). Tax hikes in recent years have not only negatively affected household disposable income, but have also kept inflation at rates higher than expected, considering the present contraction of the economy. Higher commodity prices put a brake on the inflation deceleration registered over the first half of the year, driven by the depletion of tax hikes a year ago, and thus inflation ended up increasing by 0.2pp en Q3 to 3.0% y/y, while core inflation continued to slow markedly to 1.4% y/y. As a result, we now expect annual inflation rate to be at 2.9% in 2012, 0.2pp higher than our previous estimation, although we continue to expect a significant slowdown over 2013, averaging at 1.2%.

The fifth review by the troika, praised again Portugal's efforts, and loosened fiscal targets

The troika mission completed its fifth review in late October, and again offered a positive assessment of the overall adjustment effort. After evaluating the correction of other imbalances, such as the current account deficit, the troika has loosened the fiscal targets, which is also in line with the perceived fiscal "fatigue" generally suffered by the peripheral countries. It again encouraged the country to continue its structural reforms (that is, the labour market and price competitiveness) as a way of boosting long-term growth.

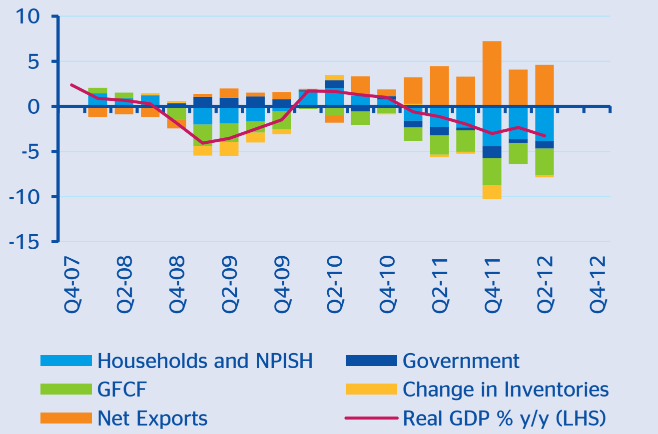
The 2013 budget is sufficient to reach targets, but is heavily weighted towards higher taxes

In the middle of October, following approval by the troika of the sixth tranche of assistance, the government announced details of its 2013 budget aimed at attaining the new target of -4.5%. The measures amount to a total of €5.3bn (3.2% of GDP). This figure is earmarked to cover the following: (a) a deficit reduction of 0.5pp over 2012 and 2013; (b) offsetting some of the temporary measures implemented in 2012, which are equal to 1% of the GDP; (c) an expected interest payment (0.1pp) and (d) the worsening of the macro-economic scenario (1.6pp of GDP).

The macroeconomic scenario envisaged by the government is the same as that of the IMF: that is, a fall in activity of 1%, which is somewhat more negative than our forecast.

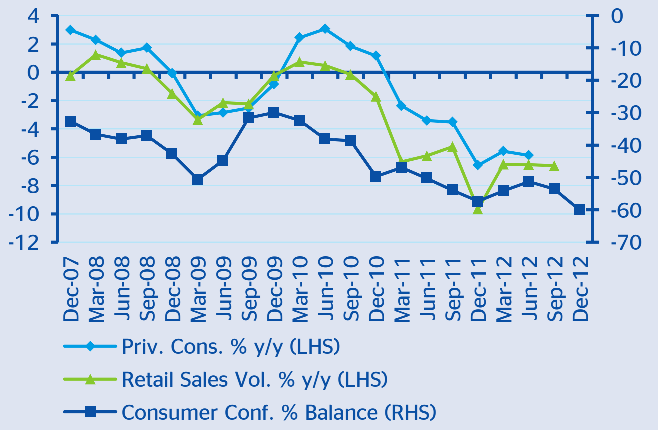
The reaction to the budget has been negative, partly owing to inertia following the initial plans (ultimately not adopted) of increasing workers' social security contributions and reducing employers' contributions, a sort of internal devaluation that was strongly opposed by a number of political parties and even criticized from within the coalition government. Available data to September on budget execution show an improvement on last year, but this is mainly due to transfers from bank pension funds. By items, containment of expenditure has been effective, but has been overshadowed by higher interest spending. On the revenue side, tax collections have fallen, reflecting a larger-than-expected impact on economic activity.

Chart 19
**Portugal:
GDP growth (% y/y) and contribution by components**



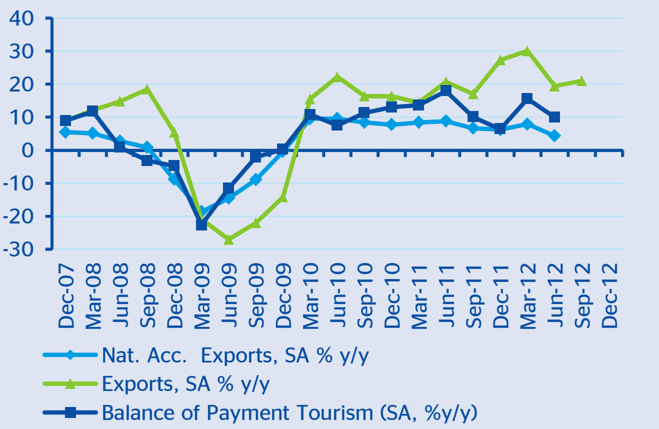
Source: INE and BBVA Research

Chart 20
**Portugal:
Private Consumption, Retail Sales and Consumer Confidence**



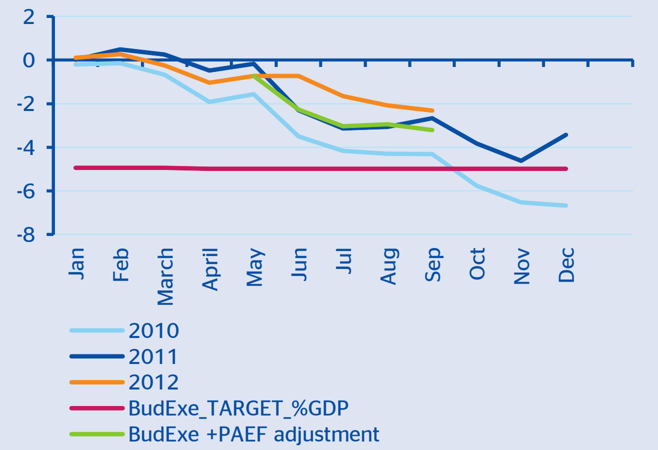
Source: European Commission, INE and BBVA Research

Chart 21
Portugal: External sector



Source: INE and BBVA Research

Chart 22
Portugal: Budget execution % of GDP



Source: DGO and BBVA Research

Box 2. United Kingdom: after a higher than expected growth in Q3, we expect a modest recovery in 2013 based on domestic demand

Growth in the third quarter surprised on the upside

The growth estimate for Q3 at 1% q/q was a positive surprise. This rebound is partly explained by the positive impact of the Olympic Games; nevertheless, the effect is expected to be temporary and does not point to a sustained recovery of economic activity.

Still limited data on activity for October show signs of weakness. Both manufacturing and services PMIs fell, reaching 47.5 and 50.6 respectively. Construction PMI keeps the pace. Gfk consumer confidence remains weak and in October the gains registered in the last month were lost and now prints at -30. This survey shows that households are especially worried about their future financial situation. Credit both to households and non-financial corporations is not showing signs of recovery. During the fourth quarter of the year the "Funding for Lending Scheme (FLS)" announced by the government to boost private credit enters into force, but it is unlikely that it will be effective in the short-run.

Labour market recovers, but productivity declines

The unemployment rate registered a decline of 0.5pp since the end of 2011, and now is at 7.9%. Employment creation has been sustained along this year, but it is expected to slowdown in Q4 together with activity. In any case, the good performance in the labour market is not accompanied with an increase in economic activity, leading to a decline in labour productivity. A possible explanation is that the wage decline is leading firms to hire, but this is not matched by an increase in consumption or demand, as a consequence of the fiscal adjustment and the widespread uncertainty. In any case, the latest surveys suggest that the labour market boom might have come to an end.

The worsening of global demand has led to a decline in exports

Trade deficit widened in August to reach the 9.8bn GBP, as a consequence of a sharp decline in exports, not only to the eurozone, but also to the US. Business surveys in September and October point to an intensification of this worsening as export orders keep on falling. The contribution of the external sector to growth is expected to be flat in Q3.

The Budget may contain additional adjustment measures

Budget execution data from April to September show a significant improvement with respect to the previous fiscal year, but this is explained by the transfer from the Royal Mail pension fund that took place on April. Excluding this transfer, the Budget execution hardly shows any improvement, but shows a higher than expected resilience to the deterioration of the economic cycle. In spite of the intense debate regarding the pace of the fiscal adjustment, it is expected that the budget (to be submitted in early December) will contain additional adjustment measures.

Inflation moderates, but remains above 2%

In spite of slowing to 2.2% in September, inflation remains persistently above the 2% threshold. The recent hike in oil prices leads us to forecast that these levels will not change up to the end of this year.

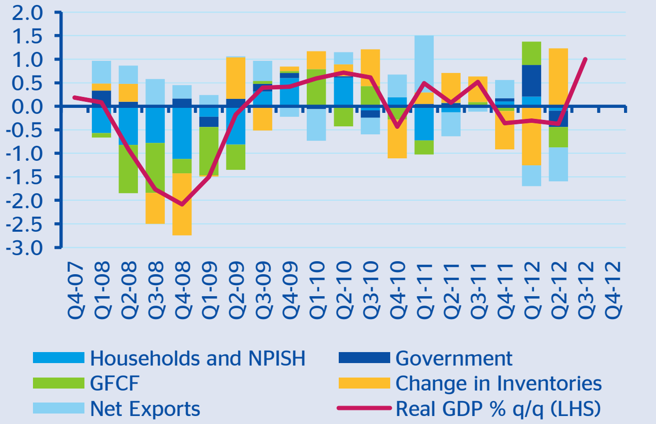
Prospects for 2013 lie in a recovery of domestic demand

Our forecast of growth for 2013, after a 2012 that will close in red (-0.1%) as a consequence of the worsening in net exports (-0.9pp), relies on a recovery based on consumption and investment, supported by the Quantitative Easing programme of the Bank of England as well as the positive base effect from the end of this year. More precisely, we expect a recovery in private consumption up to 1.5% from a 0.7% registered this year and of a 5.3% in investment. Exports will recover timidly, but imports will bounce back more vigorously leading to a negative contribution from the external sector. Inflation is expected to continue to moderate and to average 2% in 2013.

The recent surprise in economic activity delays the expansion of the Quantitative Easing programme

Last purchases of the latest round of the QE programme will take place in November, and the discussion on the convenience of enlarging again the programme is still open. However, given the good performance in Q3, it seems that the urgency for such a decision has diminished and we do not expect any change in the forthcoming MPC meeting. The MPC members are showing doubts about the effectiveness of the latest tranches in stimulating demand. We expect that the target will remain at 375bn GBP and interest rates at 0.5%.

Chart 23
UK: GDP growth (% q/q) and contribution by components

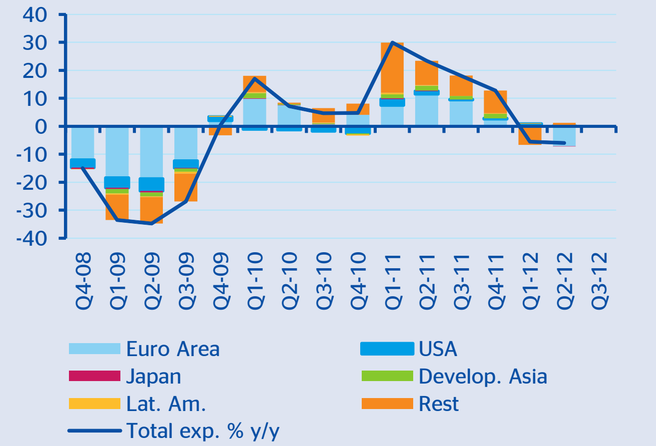


Source: Eurostat and BBVA Research

Chart 24
UK: Labor market

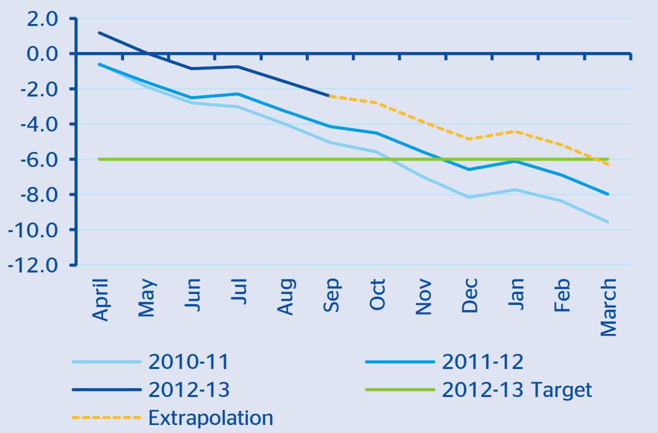
Source: ONS and BBVA Research

Chart 25
UK:
Contribution to exports growth by destination



Source: IMF and BBVA Research

Chart 26
UK: Public sector net borrowing excluding financial interventions (% of GDP)



Source: ONS and BBVA Research

5. Tables

Table 2
Eurozone forecasts

(YoY)	2009	2010	2011	2012	2013
GDP at constant prices	-4.3	1.9	1.5	-0.5	0.3
Private consumption	-0.9	0.9	0.1	-1.0	0.0
Public consumption	2.6	0.7	-0.1	-0.1	-0.5
Gross Fixed Capital Formation	-12.7	-0.3	1.6	-3.6	-0.6
Inventories (*)	-0.9	0.6	0.1	-0.5	0.0
Domestic Demand (*)	-3.6	1.2	0.5	-1.8	-0.3
Exports (goods and services)	-12.4	11.0	6.4	3.1	3.2
Imports (goods and services)	-11.0	9.4	4.2	0.1	2.2
External Demand (*)	-0.8	0.7	1.0	1.3	0.5
Prices and Costs					
CPI	0.3	1.6	2.7	2.5	1.8
CPI Core	1.3	1.0	1.7	1.8	1.5
Labour Market					
Employment	-1.8	-0.5	0.5	-0.8	-0.3
Unemployment rate (% of labour force)	9.6	10.1	10.2	11.4	11.8
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-6.3	-6.2	-4.1	-3.2	-2.5
Public debt (% GDP)	79.6	85.5	87.3	89.5	90.6
External Sector					
Current Account Balance (% GDP)	0.2	0.4	0.4	1.2	1.2

(*) Contribution to GDP growth
Source: BBVA Research

Table 3
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.1	2.4	1.8	2.1	1.8
Eurozone	-4.3	1.9	1.5	-0.5	0.3
Germany	-5.1	4.0	3.1	0.9	1.3
France	-3.1	1.6	1.7	0.1	0.5
Italy	-5.5	1.8	0.5	-2.4	-0.6
Spain	-3.7	-0.3	0.4	-1.4	-1.4
UK	-4.0	1.8	0.9	-0.1	1.3
Latin America *	-2.2	6.2	4.3	3.0	3.7
Mexico	-6.1	5.4	3.9	3.7	3.0
Brazil	-0.3	7.6	2.7	1.6	4.2
EAGLES **	4.0	8.4	6.7	5.2	5.8
Turkey	-4.9	9.2	8.5	3.0	4.5
Asia Pacific	4.1	8.2	5.8	5.2	5.5
China	9.2	10.4	9.2	7.6	7.9
Asia (exc. China)	0.8	6.7	3.5	3.7	3.9
World	-0.6	5.1	3.9	3.2	3.5

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: November 2, 2012
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-0.4	1.6	3.1	2.0	2.1
Eurozone	0.3	1.6	2.7	2.5	1.8
Germany	0.2	1.2	2.5	2.1	1.8
France	0.1	1.7	2.3	2.3	1.7
Italy	0.8	1.6	2.9	3.4	2.3
Spain	-0.3	1.8	3.2	2.5	2.3
UK	2.2	3.3	4.5	2.7	2.1
Latin America *	6.4	6.4	8.1	7.6	8.1
Mexico	5.3	4.2	3.4	4.2	3.9
Brazil	4.9	5.0	6.6	5.3	5.3
EAGLES **	2.8	5.3	6.0	4.4	4.5
Turkey	6.3	8.6	6.5	8.9	5.5
Asia Pacific	0.3	3.6	4.7	3.3	3.4
China	-0.8	3.3	5.4	3.0	3.6
Asia (exc. China)	1.0	3.7	4.3	3.4	3.3
World	2.2	3.8	5.2	4.2	4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: November 2, 2012
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Current Account (% GDP)

	2009	2010	2011	2012	2013
United States	-2.7	-3.1	-3.1	-3.0	-3.3
Eurozone	0.2	0.4	0.4	1.2	1.2
Germany	5.9	6.1	5.8	5.6	5.0
France	-1.5	-1.7	-2.2	-1.8	-1.7
Italy	-2.0	-3.5	-3.2	-1.4	-1.4
Spain	-4.8	-4.5	-3.5	-1.4	-0.5
UK	-1.6	-3.9	-2.2	-3.6	-2.9
Latin America *	-0.3	-0.7	-0.9	-1.4	-1.6
Mexico	-0.6	-0.4	-1.0	-1.0	-1.4
Brazil	-1.5	-2.2	-2.1	-2.3	-3.1
EAGLES **	2.6	1.5	0.8	0.7	0.6
Turkey	-2.3	-6.4	-10.0	-7.0	-7.1
Asia Pacific	3.5	3.3	1.8	1.4	1.6
China	5.2	4.0	2.8	2.5	2.8
Asia (exc. China)	2.3	2.0	1.1	0.7	0.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: November 2, 2012
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Government Deficit (% GDP)

	2009	2010	2011	2012	2013
United States	-9.9	-8.9	-8.7	-7.7	-5.0
Eurozone	-6.3	-6.2	-4.1	-3.2	-2.5
Germany	-3.1	-4.1	-0.8	-0.4	-0.4
France	-7.6	-7.1	-5.2	-4.6	-3.3
Italy	-5.4	-4.3	-3.8	-2.6	-1.9
Spain *	-11.2	-9.7	-9.4	-7.2	-5.9
UK	-5.6	-10.2	-7.8	-7.9	-6.1
Latin America **	-2.9	-2.4	-2.3	-2.3	-1.9
Mexico	-2.6	-3.4	-2.7	-2.6	-2.3
Brazil	-3.3	-2.5	-2.6	-1.9	-1.5
EAGLES ***	-3.8	-2.5	-1.9	-2.2	-2.0
Turkey	-5.5	-3.6	-1.4	-2.0	-1.6
Asia Pacific	-4.8	-3.6	-3.7	-3.8	-3.5
China	-2.8	-2.5	-1.1	-1.8	-1.8
Asia (exc. China)	-6.1	-4.5	-5.5	-5.2	-4.6

* Excluding aid to financial sector
** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
*** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: November 2, 2012
Source: BBVA Research

Table 7

Financial Variables

Official Interest Rates (End period)	2009	2010	2011	2012	2013
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	0.75	0.75
China	5.31	5.81	6.56	5.75	5.75
10-year Interest Rates (Avg.)					
United States	3.2	3.2	2.8	1.8	2.1
EMU	3.3	2.8	2.6	1.6	2.1
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.72	0.76	0.72	0.78	0.77
EMU	1.39	1.33	1.39	1.28	1.30
UK	1.56	1.55	1.60	1.59	1.66
China (RMB per USD)	6.83	6.77	6.46	6.32	6.26

Forecast closing date: November 2, 2012
Source: BBVA Research

Table 8

Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	0.6	0.3	0.8	1.7	0.9	1.1
Public consumption	3.2	3.0	1.7	1.0	0.8	0.4
Gross Fixed Capital Formation	0.6	-11.5	5.6	6.4	-1.0	2.5
Inventories (*)	-0.1	-0.8	0.6	0.2	0.0	0.0
Domestic Demand (*)	0.9	-2.2	2.4	2.4	0.5	1.2
Export	2.3	-12.8	13.4	7.9	3.8	4.1
Import	3.0	-8.0	10.9	7.5	3.3	4.5
Net export (*)	-0.1	-2.9	1.6	0.6	0.5	0.1
GDP	0.8	-5.1	4.0	3.1	0.9	1.3
Inflation	2.8	0.2	1.2	2.5	2.1	1.8

(*) Contribution to growth
Source: BBVA Research

Table 9

France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	0.2	0.3	1.5	0.3	-0.1	0.4
Public consumption	1.2	2.6	1.7	0.8	0.8	0.0
Gross Fixed Capital Formation	0.1	-10.4	1.0	2.6	0.5	0.7
Inventories (*)	0.3	-1.3	0.1	1.0	-0.5	0.0
Domestic Demand (*)	0.2	-2.6	1.6	1.7	-0.3	0.4
Export	-0.6	-11.8	9.2	4.6	2.6	2.7
Import	0.6	-9.5	8.4	5.3	1.0	2.1
Net export (*)	-0.4	-0.5	0.0	0.0	0.4	0.1
GDP	-0.2	-3.1	1.6	1.7	0.1	0.5
Inflation	3.2	0.1	1.7	2.3	2.3	1.7

(*) Contribution to growth
Source: BBVA Research

Table 10

Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-0.8	-1.6	1.2	0.2	-3.2	-0.9
Public consumption	0.6	0.8	-0.6	-0.9	-1.6	-1.5
Gross Fixed Capital Formation	-3.8	-11.7	1.7	-1.2	-8.6	-2.0
Inventories (*)	0.0	-1.1	1.2	-0.6	-0.8	0.0
Domestic Demand (*)	-1.2	-4.3	2.1	-0.9	-4.7	-1.2
Export	-2.8	-17.7	11.4	6.3	0.6	1.9
Import	-2.9	-13.6	12.4	1.0	-7.6	-0.4
Net export (*)	0.0	-1.2	-0.4	1.4	2.3	0.7
GDP	-1.2	-5.5	1.8	0.5	-2.4	-0.6
Inflation	3.5	0.8	1.6	2.9	3.4	2.3

(*) Contribution to growth
Source: BBVA Research

Table 11
Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	1.3	-2.3	2.1	-4.0	-5.4	-1.3
Public consumption	0.3	4.7	0.9	-3.8	-2.5	-1.9
Gross Fixed Capital Formation	-0.3	-8.6	-4.1	-11.3	-15.3	-5.6
Inventories (*)	0.0	-1.1	0.1	-0.5	-0.1	0.0
Domestic Demand (*)	0.9	-3.6	0.9	-6.2	-6.9	-2.1
Export	-0.1	-10.9	8.8	7.5	4.7	4.0
Import	2.3	-10.0	5.4	-5.3	-6.5	0.3
Net export (*)	-1.0	0.6	0.5	4.5	4.1	1.4
GDP	-0.1	-2.9	1.4	-1.7	-2.8	-0.7
Inflation	2.7	-0.9	1.4	3.6	2.9	1.2

(*) Contribution to growth
Source: BBVA Research

Table 12
Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-0.6	-3.8	0.7	-1.0	-2.0	-2.9
Public consumption	5.9	3.7	1.5	-0.5	-3.6	-6.9
Gross Fixed Capital Formation	-4.7	-18.0	-6.2	-5.3	-9.7	-7.5
Equipment and other products	-2.9	-23.9	2.6	2.3	-7.6	-3.7
Construction	-5.8	-16.6	-9.8	-9.0	-11.8	-10.0
Housing	-9.1	-23.1	-10.1	-6.7	-6.8	-8.4
Other construction	-1.6	-9.1	-9.6	-11.0	-16.3	-11.7
Inventories (*)	0.1	0.0	0.1	-0.1	0.0	0.0
Domestic Demand (*)	-0.5	-6.6	-0.6	-1.9	-4.0	-4.7
Export	-1.0	-10.0	11.3	7.6	3.8	8.2
Import	-5.2	-17.2	9.2	-0.9	-4.7	-1.8
Net export (*)	1.4	2.9	0.3	2.3	2.6	3.3
GDP	0.9	-3.7	-0.3	0.4	-1.4	-1.4
Inflation	4.1	-0.3	1.8	3.2	2.5	2.3

(*) Contribution to growth
Source: BBVA Research

Table 13
UK: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-1.6	-3.1	1.3	-0.9	0.7	1.5
Public consumption	1.6	0.8	0.4	0.2	2.0	-1.4
Gross Fixed Capital Formation	-4.6	-13.7	3.5	-2.4	2.0	5.3
Inventories (*)	-0.4	-1.0	0.9	0.4	-0.3	0.2
Domestic Demand (*)	-1.9	-5.1	2.4	-0.3	0.8	1.5
Export	1.2	-8.2	6.4	4.5	-0.3	2.8
Import	-1.8	-11.0	8.0	0.5	2.6	3.2
Net export (*)	0.9	1.1	-0.6	1.2	-0.9	-0.2
GDP	-1.0	-4.0	1.8	0.9	-0.1	1.3
Inflation	3.6	2.2	3.3	4.5	2.7	2.1

(*) Contribution to growth
Source: BBVA Research

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