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Economic Outlook

Europe

Third Quarter 2013
Economic Analysis

- **The world economy is slowing,** but continues to support the European foreign sector.
- **Fiscal and monetary policies ease slightly** and support the recovery.
- **Germany continues to grow more than the rest of the area,** although the performance of peripheral countries is improving.
- **The risks for recovery come from growth in the rest of the world** and the lack of progress in reforms and banking union in Europe.

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Closing date: August 2, 2013

1. Editorial: eurozone recovery is underway

The eurozone finally seems to be coming out of several quarters of recession, although at a sluggish rate and amid uncertainty. Following the collapse of activity in the fourth quarter of 2012 and a worse-than-expected recession in the first quarter, the GDP may have grown in the second quarter of the year, thanks mainly to growth in Germany, and should continue growing in the second half of the year and in 2014. Nonetheless, the recovery should advance at a relatively slow pace due to the ongoing adjustments in the periphery, the commitment for fiscal consolidation in nearly all the countries in the area and, above all, the persistent fragmentation of financial flows and sluggish lending.

The factors that have determined the area's macroeconomic performance have changed over the last three months. Fiscal policy has been eased moderately, as we expected, above all in the periphery and in countries such as France and Holland, with the postponement of fiscal targets permitted by the European Commission within the framework of the European Semester. The 3% of GDP fiscal deficit target has been put off for one year for Portugal and the Netherlands, and for two years for Spain, France and Slovenia. This means less fiscal consolidation for this year and the next in the eurozone, and also following the rule of setting fiscal targets in structural terms and not in the nominal, as we feel it ought to be. Even so, fiscal policy will continue to be moderately restrictive in 2013 and 2014, with a reduction in the fiscal deficit to 2.8% of GDP in 2013 and 2.2% in 2014, from 3.7% last year.

Monetary policy has also become looser. The cut in benchmark rates by the ECB to 0.50% in May and the change in the communication policy announced in July is a commitment to forward guidance by the ECB and the announcement that official interest rates will remain at low levels for at least the next year. This policy also reflects the desire of not to be affected by the undesirable effects that the Fed's announcement on the progressive phasing-out of quantitative easing has had on financial markets. We do not expect any hikes in official rates in the coming quarters (perhaps an additional cut, should the cyclical situation worsen).

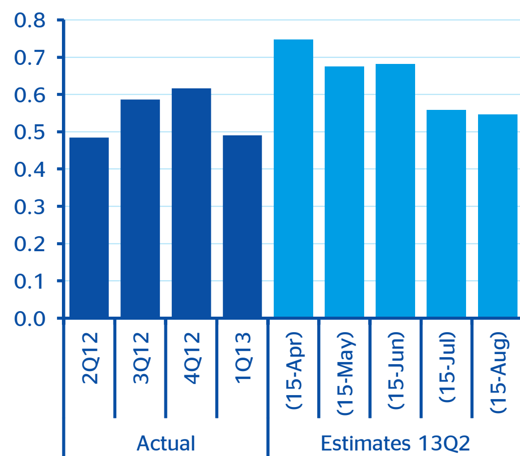
Despite historically low interest rates, financial conditions continue to differ widely across countries due to the ongoing financial fragmentation in the eurozone. The progress made towards banking union, which is one of the keys for normalizing the flows of funding in the area, has been less ambitious than necessary and slower than expected, although the project is still underway. Thus, the common supervisory mechanism will be implemented, but not before September 2014 (three months later than planned), while the European summit at the end of June made no progress on the common European resolution mechanism. For the latter, there exists a more centralizing proposal by the European Commission and another one by Germany and France that advocates a coordinated network of national resolution authorities that would eventually lead to a single authority, but only in the medium term and through an amendment to the treaty. However, progress has been made on the common resolution directive, which approves the resolution criteria based on the premise that government aid will only arrive once the private sector has shared in the losses. And as regards government aid, the ESM recapitalization funds are relatively meager (€60bn), but expandable, so it seems unlikely that the vicious circle between banking and sovereign risk in the periphery will be broken.

Consequently, it seems that the way out of recession will continue to depend on the foreign sector. Our forecasts point to robust growth in the global economy in 2013 and 2014, although the recent economic slowdown in China and other emerging countries is casting doubts on the recovery in Europe. According to our forecasts, due to the strong negative carry-over effect in the last quarter of 2012 and the first quarter of 2013, the eurozone's GDP will decline by -0.4% in 2013 (compared with -0.1% forecast three months ago), but we maintain our recovery scenario after the second quarter of this year, and economic activity should grow by around 1% in 2014. Germany continues to be the most balanced economy in the eurozone and will therefore be the first one to leave the recession behind, thanks, above all, to the strength of its foreign sector and domestic demand support, while the prospects for other core countries in Europe are now more negative than three months ago (with France undergoing a mild recession, but also Holland and Finland). Our forecasts for the periphery have barely changed (except in Italy, slightly downward), and we should see a strong decline in GDP on average for 2013 and a slight recovery in 2014.

2. Global growth: no improvements until 2014, diversified risks[1]

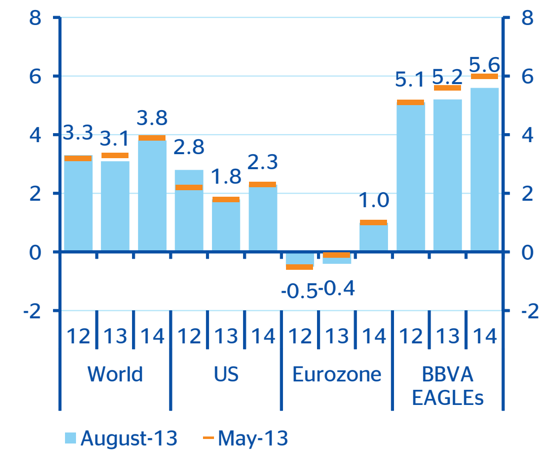
In the first half of 2013 world growth has remained at around 3%, near the level registered in 2012. In the second quarter of the year the indicators released have continued to moderate and point to quarterly growth of 0.5% - 0.6% (see Chart 1). This moderation is partly due to increased volatility and recent tensions in finance conditions, which have been far more moderate than the disruptive events seen in recent years (the collapse of Lehman Brothers, institutional problems in Europe, restructuring of Greek debt, etc). Now, these tensions are the result of the uncertainty of "nearly normal times". Firstly, the Fed's announcement explaining the strategy for reversing the expansion of its balance sheet, against a backdrop of gradual economic recovery. The markets reacted with a strong increase in long-term rates in the U.S. which at the end of July and for a 10-year term stand at between 70 and 80 basis points above the levels reported for the first half of May. Secondly, the tensions registered in the interbank lending market in China are a warning signal of the Chinese central bank's concern over the strong growth in lending and in "shadow banking". In addition, the risk indicators in the eurozone once again deteriorated to levels near those reached during the banking crisis in Cyprus due to the lack of significant progress in building a banking union, and to the political uncertainty in some peripheral economies, particularly Portugal. Finally, the evident slowdown in major emerging markets exacerbated the capital outflows and the risk aversion derived from a less favourable global liquidity. Faced with all these events, investors have incorporated an environment of lower growth in emerging markets and gradual normalization of the monetary policy in the U.S.

Chart 1
Growth of global GDP according to the BBVA-GAIN model (% q/q)



Source: BBVA Research

Chart 2
GDP growth



Source: Haver and BBVA Research

Thus, the prospects for the near future point to a gradual global recovery to near 4% in 2014, with an improvement even in the second half of 2013 in some economies. The most developed economies will continue to be supported by their central banks and, in the case of the eurozone, will benefit from a fiscal consolidation effort less intense than the one registered in 2012. In the emerging markets the slowdown underway will be halted helped by improved conditions in the developed economies, and also by the prudent use of the room for manoeuvre afforded by domestic economic policies in some countries. The recovery will be stronger in Latin American economies, while the improvement in Asia will be slowed down by the downturn in China, which until now is narrow but has continued almost uninterruptedly since 2008 and will remain at least in 2014. This moderation is related to the gradual weakening of a credit- and investment-intensive growth model which should speed up its rebalancing to give more weight to consumption.

1: For further information, see Global Economic Outlook 3G13 in www.bbvaresearch.com

This highly likely global baseline scenario still has some uncertainty ranges somewhat more tilted to the downside than to the upside, but with no high probability of disruptive events that would prevent an outlook of, at least, sustained global growth in 2013 and 2014 near 2012 levels. This diagnosis is a sign of a return to normality in the economic landscape.

The downside risks that could once again delay global recovery (relatively less likely than on other occasions) would basically be the persistence of events that complicated the outlook last quarter to the point of generating additional tensions in the conditions for accessing finance and a decline in the confidence of the economic agents. This could be: i) a new, intense and continued fall in the price of risk-less assets like the U.S. Treasury bond as a result of a market less compliant with the wishes of the Federal Reserve; ii) a resurgence of doubts about the progress towards the banking union and the "exceptional nature" of Greece; and iii) a sharper downturn in the Chinese economy in its necessary process of economic rebalancing while it gradually adapts the adjustment to the size of its financial system. Although it is true that the authorities have room for manoeuvre to prevent "tail" events, the process of change faced by China is notable and requires extensive, ongoing and decisive reforms.

3. Growth factors: economic policy and banking union

Since the release of our last report three months ago, some of the growth factors prevailing at that time have changed. As has been stated in the previous chapter, the global growth (key to ending the recession due to led-export growth strategy in the eurozone) is somewhat weaker than expected and subject to greater downward bias. Also on the negative side, the banking union project is moving forward, but more slowly than originally planned, showing that it will clearly be a supporting factor in the medium and long term, rather than the inmediate exit from the crisis.

On the positive side, the fiscal policy in 2013 and 2014 will be less restrictive than initially expected. Although this change was generally anticipated, it seems to be having a positive effect on the economic agents' expectations. As for the financial situation and monetary policy, the effectiveness of the OMT program announced by the ECB in the summer of 2012 as a firewall has been proved, as shown by the limited impact of the successive episodes of banking (Cyprus) or political (Portugal) crises on the sovereign spreads and on financial tensions in general. The ECB has cut the official interest rate (which was not necessarily discounted) and has surprised the market with its announcement that it will maintain the rates at a low level for a long period of time, which represents a step towards a forward guidance strategy and a loosening of its stance.

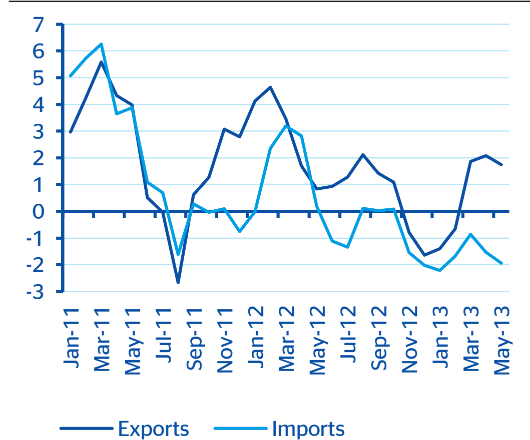
Although it is difficult to gauge the relative impact of each one of these factors, we assume in our forecasts that their impact on growth will be practically neutral. Therefore, the only change we have made to our forecasts is the incorporation of the negative data for the first quarter, which reduces the average growth expected for 2013. For the rest of this year and 2014, we maintain our scenario of the eurozone economy recovering slowly driven by the foreign sector and led by Germany.

The global environment is somewhat less positive, but will continue to support exports

The foreign environment described in the previous section is clearly less positive as regards the emerging economies, although it is still relatively positive with regard to the United States, despite the fact that a self-sustained recovery (with no support from fiscal and, especially, monetary policies) remains to be proved. Overall, the global growth forecasts have only been revised down by 0.2pp for both 2013 and 2014 to 3.1% and 3.8%, respectively, which should not entail a greater impact on exports.

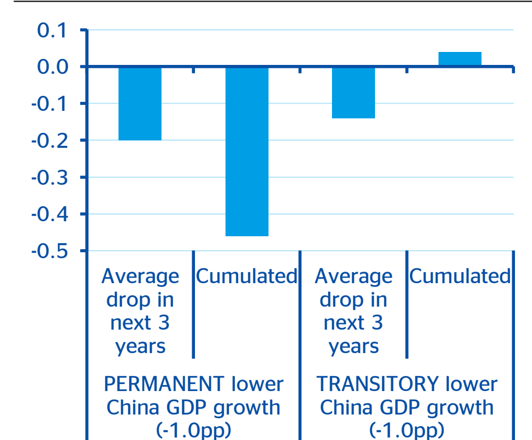
The main source of uncertainty for the eurozone comes from growth in the emerging economies, and above all from Asia, since much of the growth in exports over the last two years has come from these countries, which have been the main source of global growth. Eurozone exports went down sharply in the last quarter of 2012 (see Chart 3) and were the main source of recession in that quarter, although it seems clear that the performance over the last four months has improved substantially.

Chart 3
EMU: exports and imports (% 3m/3m)



Source: Eurostat and BBVA Research

Chart 4
Impact of lower growth in China on EMU GDP growth (pp)



Source: BBVA Research

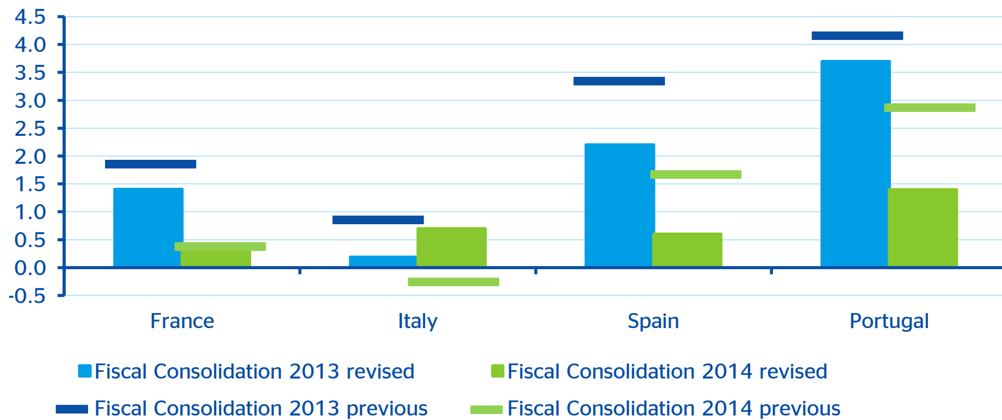
Thus, Chart 4 shows the potential impact of a sharper-than-expected downturn in China on growth in the eurozone. Our simulations show that each point of lower growth in China could result in lower growth in the euro zone of about 0.4pp of GDP, due to the direct impact of Chinese exports and the indirect impact through third countries.

A less restrictive fiscal policy has been confirmed

Following the debate on the size of the fiscal multipliers launched by the International Monetary Fund in the second half of 2012, the analysis of the stability and growth programs by the European Commission and the Ecofin led in late May to an easing of the fiscal policy for the coming years, with several countries being allowed to postpone the public deficit target of 3% of GDP. Specifically, the deadlines have been extended for five eurozone countries: Spain (two years to 2016), France (two years to 2015), Netherlands (one year to 2014), Portugal (one year to 2015) and Slovenia (two years to 2015). Outside the eurozone, the deadline was also extended for Poland. The new deficit targets for 2013 corroborate in practice the forecasts already assumed by the governments themselves and by the analysts, whether due to a greater-than-expected cyclical deterioration in most of these countries or to the delay in adopting consolidation measures in some of them. In the case of Italy, the government's new public deficit target of 2.9% for 2013 also entails an easing of fiscal policy. But because it is below the 3% limit, it has been removed by the European Commission from the list of countries with an excessive deficit procedure.

The easing of these targets does not entail an expansive fiscal policy, but rather a less contractive policy. Chart 5 shows what the level of consolidation of the primary structural deficit would be in some eurozone countries. For the monetary union as a whole, the deficit forecast for 2013 is 2.8% of GDP, and for 2014 2.2%, after the 3.7% of GDP in 2012. In terms of primary structural deficit, this means an adjustment of 0.8pp in 2013 and 0.4pp in 2014, i.e. a moderately contractive fiscal policy in both years (see Box 1).

Chart 5
Fiscal consolidation after deficit revision



Source: BBVA Research

The financial environment is marked by the knock-on effect of the U.S. Fed

Volatility has been the dominant feature on the financial markets due to the combination of several events. First and foremost, the markets, including Europe, have been guided by the expectation of a moderation of the monetary stimulus in the United States. This has combined with doubts on the success of the monetary stimulus strategy in Japan, announced in April this year, and some episodes of liquidity tensions in China that heightened fears of an abrupt adjustment of this economy. The combination of these three elements gave rise to a strong surge in volatility in all the markets, massive sales of assets and, therefore, significant drops in their prices, especially in emerging markets.

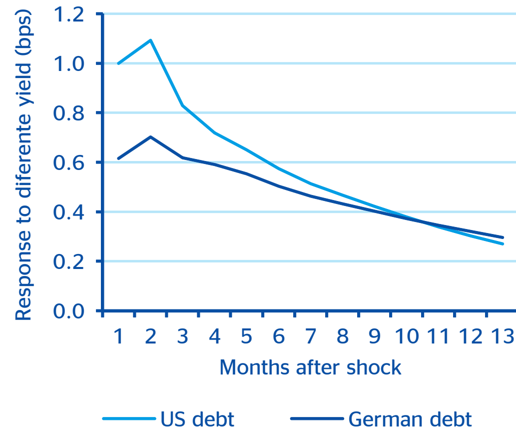
The Fed has announced its intention to moderate its rate of asset purchases in the coming months and put an end to the purchase program in the first half of 2014, as long as the economy performs in line with expectations. This announcement does not mean that the Fed is starting a cycle of tightening of monetary conditions; in fact, interest rate hikes will predictably begin well into 2015. However, the interest rate increase on the long yields of the debt curve in the United States has been very aggressive and has dragged the rest of the markets, including Europe. This movement has been halted in recent weeks, with the Fed adopting a somewhat more downward tone in its communications. Although we expect the withdrawal of the monetary stimulus in the United States to be a long process, we cannot rule out a surge of market volatility associated not only with the developments in economic data, but also with the Fed's own communications.

The debt of the countries in the north of Europe has been dragged by this movement in the U.S. curve, although the interest rate increase has been more moderate. The ECB's communication has contributed to this. At its monetary policy meeting in July it surprisingly added the concept known as "forward guidance" (see Box 2). Thus, the spread between German and U.S. debt has increased at levels unseen in the last 7 years. Looking ahead, the lack of correlation between U.S. and German bonds will be difficult to maintain; both historical evidence and the expectations of economic recovery in the eurozone point in this direction. German and U.S. debt reacts similarly to global events. But as shown in Chart 6, the yield of German debt has traditionally been connected to the yield of U.S. debt, even after taking into account the global growth and financial stress shocks.

Chart 6
10-year interest rates in the U.S. and Germany (% and bp)

Source: Bloomberg and BBVA Research

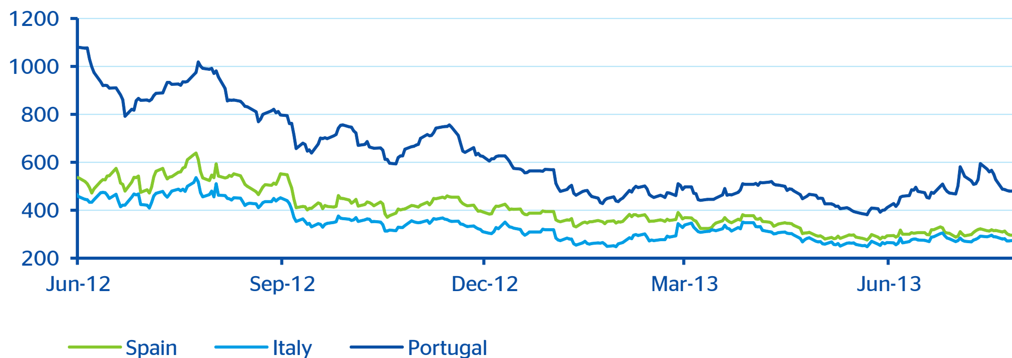
Chart 7
Development of the yield of different debts in the event of an unexpected 1-bp increase in the yield of U.S. debt*



* Controlling by surprises in the VIX and in our global activity index GAIN.
Source: BBVA Research

The debt of peripheral countries has also been dragged by this movement, although the spread with Germany has remained relatively stable in both Spain and Italy (see Chart 8). As opposed, for example, to what has been seen in emerging markets with a strong increase in risk premiums, the risk in peripheral countries has remained contained. Moreover, the contagion effect between peripheral countries has been contained, as seen in recent months, while one year after its announcement the OMT program continues to have an effect. The political crisis in Portugal, which has caused a significant increase in its risk premium, has barely had an effect in countries like Spain or Italy. However, the risk premium reduction process that began one year ago has been halted, and improvements are expected to be very gradual in the future.

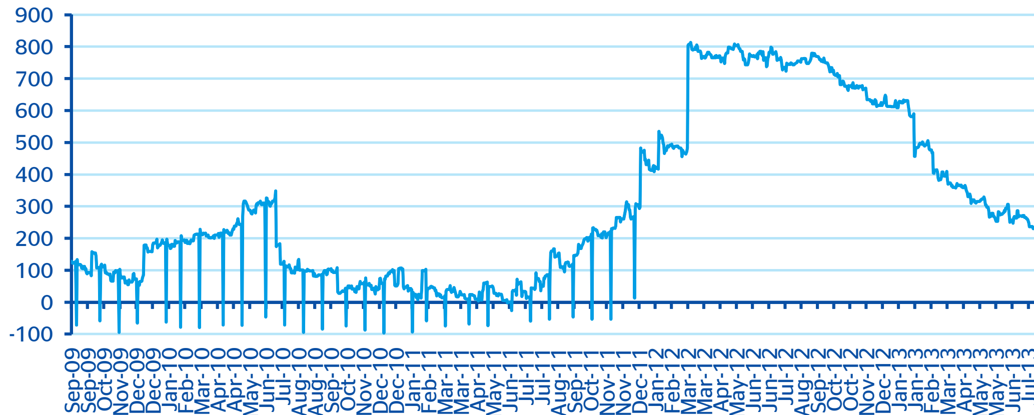
Chart 8
Risk premium* in Spain, Italy and Portugal (bp)



Note: 10-year interest rate spreads with Germany.
Source: Bloomberg and BBVA Research

As for bank funding, banks have slowed down the rate of early repayment of LTROs in these months, following a more aggressive repayment during the first opportunities in the first quarter of the year. This means that the excess liquidity of the European banking system stands at around €230bn, according to available data. The reduction of TARGET positions in creditor and debtor countries also seems to be stabilizing. The quarter has been marked by a low volume of issuances, compared with the number registered at the beginning of the year. Also, the new issuances have come mainly from banks in core countries.

Chart 9
Excess liquidity (billions of euros)



Source: Bloomberg and BBVA Research

The banking union process continues, but with obstacles and delays

The fragmentation of the financial markets in the eurozone continues to be one of the key factors of the crisis. Making funding costs much higher in the periphery than in the north of the eurozone partly explains the different macroeconomic performance in the different countries in the area. The strategy for reversing this fragmentation involves, on the one hand, reforms and reduction of imbalances (especially fiscal) in the peripheral countries and, on the other hand, institutional reforms at European level. The latter, after leaving aside the movements towards an eventual fiscal union in mid-2012, are now focused on banking union.

The European summit in December 2012 set a rather well-defined schedule for banking union, with a first step focused on a common supervisory mechanism (SSM) around the ECB, a second step for setting up a common resolution mechanism (SRM) and a third step with a common deposit guarantee fund which has been put off the table. The banking union project is moving forward, although with some delay. The SSM will come into operation in September 2014 (instead of in mid-2014, or even at the beginning of 2014, as planned originally). No decision was made on the SRM at the June summit, as had been planned originally, and the decision will be made in the second half of this year, since the European Commission's proposal for the SRM was published in July.

However, some major progress has been made recently as regards the banking resolution framework, which is very positive for the banking union project to continue moving forward:

- The Ecofin has reached an agreement on the text of the banking resolution Directive (Bank Recovery and Resolution Directive, BRRD) and negotiations will now begin between the Council and the European Parliament for the drafting of a final text by the end of this year that should become effective, in part, in January 2015, and in 2018 as regards bail-in assets. Although the Directive cannot be assessed until the final text is published, it is broad, includes a common framework for country intervention in the event of banking crises and, in addition to establishing the rules for early prevention and intervention in crises by banks and resolution authorities, defines the instruments for banking resolution, which include as a last step the restructuring of liabilities, the main novelty of the Directive. The BRRD's proposal establishes the liabilities excluded from the restructuring and their hierarchy. The Directive proposes a new bail-in framework where shareholders and creditors of distressed banks will be the first to bear the losses (covering losses of 8% of liabilities and shareholders' funds). The Resolution

Fund could come into play next (up to 5% of liabilities and shareholders' funds) and, lastly, in exceptional circumstances and if the rest of the liabilities with no guarantee or preference have been removed or fully converted, alternative sources of funding would be used (for example, the European Stability Mechanism).

- The Eurogroup reached an agreement whereby the ESM may directly recapitalize the banks, with a limit of €60bn, although the ESM Council may increase this amount in exceptional circumstances. This recapitalization is relevant for financial institutions in countries facing financial stress that cannot allocate public funds. Recapitalization will be subject to the current restructuring rules (i.e. up to junior debt), although with the possibility of applying new rules (up to senior debt). The ESM would only contribute funds from 4.5% of the liabilities to the capital required by the EBA (9%). The first funds, up to 4.5%, are provided by the country (with a few exceptions). This aid would require a formal request from the country, which would entail the application of a MoU, and could be applied retroactively (which is relevant in the case of Ireland).
- The European Commission's proposal on the banking resolution mechanism (SRM) must be discussed by the countries and approved by the current European Parliament before its dissolution (in spring 2014). The proposal gives the last word on the restructuring process to the European Commission itself, which will predictably be opposed by Germany that prefers a less centralized mechanism consisting of a network of national resolution authorities. The European Commission's proposal also includes funding for the Resolution Fund by the financial industry, up to 1% of the deposits covered (around €55bn), which would be funded in 10 years (or more if the fund is used before than).

Box 1. Less restrictive fiscal policy following the easing of targets

At the end of May, the European Commission extended the deadline for reducing excessive deficits in six countries (Spain, France, the Netherlands, Portugal, Poland and Slovenia). The recommendation was subsequently approved by Ecofin at its meeting on June 21. As a result, four countries (Spain, France, Poland and Slovenia) will have two more years to reduce their deficits under 3% of GDP, and the other two (Portugal and the Netherlands) will have one additional year.

This reflects the new setting in Europe of not increasing the fiscal adjustment when the main reason for non-compliance is a worse than expected cyclical situation. This will have a positive impact on the eurozone's economic performance this year, but particularly next, with greater easing in fiscal consolidation. We will focus the analysis below on the fiscal situation of France, Italy, Portugal and Spain.

France

The deficit target has finally been set at 3.9% of the GDP for 2013. This is 0.2pp above the 3.7% presented by the government in its budget plans, which had already been revised up from 3% due to the worsening economic growth projections (from 0.8% to 0.1% in 2013) and a higher than expected deficit in 2012 (observed at 4.8%, compared with the forecast 4.5%). This new target is closer to our forecast at the beginning of May (3.8%). It means that fiscal consolidation will be relaxed slightly in 2013, from 1.9% to around 1.4% of GDP.

The cumulative central government deficit to May amounts to €72.6bn, an increase of €3bn (4.4% y/y) on the figure for the same period in 2012. By components, till May, cumulative fiscal revenue was higher than observed in the same period in 2012 (up 5.8% y/y), but these positive figures were not higher enough to counter the increased cumulative expenditure in the same period (up 6.2% y/y).

The figures are, however, consistent with the new deficit forecast (3.9% of GDP), and though it is true that we have revised GDP growth for 2013 down slightly (from 0% to -0.1%), the cyclical deficit has hardly been affected and there will only be a deviation of 0.1pp if growth is finally worse than our estimates (for example, a negative 0.2%, as forecast by the IMF).

Our estimate of the probability of non-compliance is slightly below that calculated by the court of auditors in France. In its annual report presented at the end of June they warn that a negative growth of -0.2% could involve lower revenue and higher social expenditure, with a net effect on deficit growth of €6bn (0.3% of GDP), 0.2pp above our estimates.

Overall, we expect the French government will achieve the new fiscal target with a structural adjustment of 1.4 percentage points of GDP. This will reduce the structural deficit to 2.3% of GDP; the remaining 1.6% as cyclical deficit.

Italy

At the end of May the European Commission recommended suspending the excessive deficit procedure to which Italy had been subject since 2009, when the deficit reached a high of 5.5% of GDP. Starting in that year, the deficit began to fall steadily to 2.9% of GDP in 2012, thus complying with the deadlines imposed by the European Commission. The deficit target set for 2013 (2.9% of GDP) has been revised upward from the 1.7% announced at the start of 2012. This revision is mainly due to worsening growth forecasts (from -0.2% to -1.3% in 2013), and the inclusion of the impact of government debt payments, valued at €40bn (2.6% of GDP).

Although it is true that preliminary data for June show a surplus of €14.1bn, which is practically 2.5 times the surplus obtained in June 2012 (€5.6bn), cumulative data through June indicate that the deficit has grown by €12.3bn (increase of 41% y/y) to 3.6% of GDP (around 2.3% according to the criterion used by the Commission). We only have a breakdown of this figure through April. It clearly shows that this deviation is mainly due to that the cumulative revenue through April has grown by 3.6% y/y, while expenditure has increased by 13.4% y/y.

These data for budget execution would indicate a worsening cycle, which we have included in our deficit forecast. For that reason we now expect that the deficit will reach 3.1% of GDP, a deviation of 0.2pp from the target, due wholly to the country's worsening economic growth forecasts (from -1.3% y/y initially to -1.8% in 2013).

This forecast (3.1% of GDP) could rise by a further 0.4pp if the VAT increase to 22% (from 21%) is not implemented and the suspension of the tax on ownership of the principal residence is maintained.

Portugal

In March, following the seventh review by the Troika, it became clear that there was a need to reconsider the fiscal adjustment, triggered by a worse economic performance and less optimistic forecasts for 2013. In May, the European Commission recommended extending the term for reducing the excessive deficit and at its meeting on June 21, Ecofin approved these recommendations. As a result, Portugal's deficit targets are now officially 5.5%

for 2013, 4% for 2014 and 2.5% for 2015. Although it is true that the deficit target has been eased by 1pp (from the previous 4.5%), the structural adjustment remains practically unchanged (at around 3.6%), mainly because much of the revision can be attributed to cyclical deterioration.

The budget execution data, available for January-May, indicate that Portugal will comply with the target set by the economic and financial aid program (5.5% of GDP). The cumulative deficit through May amounts to €1.7bn (1.6% of GDP): cumulative fiscal revenue grew by 6% y/y, while expenditure increased by 7% y/y.

Incorporating these data into our models, we estimate that the deficit at the end of the year will amount to 5.5% of GDP. However, these estimates do not include the effect on fiscal policy measures of political instability in early July or the possible effect of the local election results in September.

Spain

The budget execution results so far show the major fiscal consolidation effort that is still being made in structural terms. In 2013 as a whole, although we expect fiscal adjustment policies to continue, it is unlikely that they will be sufficient to offset the negative effects of the slump in economic activity on revenue and expenditure and the expected increase in debt interest payments. Therefore, BBVA Research forecasts suggest that in 2013 the economic cycle will drain nearly a percentage point of GDP from expected revenue, affecting both taxes on output and taxes on income, absorbing their structural improvement. Thus public revenue will remain around 36.7% of GDP, +0.3pp above the figure for 2012. For its part, the adjustment in expenditure will be focused on intermediate consumption, on investment expenditure (which will moderate its fall compared with previous years), and, to a lesser extent, on wages, due to the continued implementation of public service reform measures and the restructuring of the public sector as a whole.

In this situation, where measures that had been announced were not implemented, the public deficit in 2013 will increase by around 1.7pp of GDP as a result of the economic deterioration of 1pp, as well as around 0.7pp more due to the structural increase in social benefit payments and increased debt interest payments. Thus taking into account the both announced and implemented measures, the deficit in 2013 will be around 6.5% of GDP, in line with the new stability target approved by the European Commission at the end of May. This flexibility of the stability targets will also ensure the target approved for 2014 can be met, when the public deficit will be around 5.8% of GDP, as both to the economic cycle and the structural improvement of income and expenditure will begin to correct the fiscal deficit.

Overall, the structural balance of the Spanish public sector will be around 1.5% of GDP at the end of 2014, and thus accumulate nearly 6pp of correction since 2011.

Box 2. Forward guidance: the new strategy for the ECB's monetary policy?

At its monetary policy meeting held in July, the European Central Bank (ECB) adopted a forward guidance strategy, stating that rates would remain at current low levels for a long period of time. This was an unexpected decision, with the ECB departing for the first time from its traditional policy of "never pre-commitment". The ECB is thus heading towards a more explicit communication of its goals and its long-term monetary policy strategy. The central bank also explicitly stated the three pillars/goals that guide its monetary policy, adding that the maintenance of low rates was based on its expectations for three variables: inflation under control in the medium term, widespread weakness of the real economy and moderate performance of the monetary aggregates in the medium term.

But the ECB has not been more explicit about its future monetary policy. Among other things, it has not defined how long a "long period of time" is, nor it has conditioned its future rate hikes on measurable macroeconomic targets (thresholds for certain macroeconomic variables, as in the case of the Fed).

This new communication strategy announced by the ECB is not new at global level, as it has been applied successfully over the last two decades by an increasingly number of central banks as they were reaching monetary policy rates close to zero, including the Fed (which adopted the forward guidance strategy implicitly in August 2003 and explicitly in August 2011). The adoption of this strategy has a number of goals, including anchoring expectations and reducing market volatility and, in the specific case of the ECB, also reducing the recent toughening of long-term funding costs -a situation that has been hampering the ECB's expansive monetary policy over the last two months-. Although the President of the ECB, Mario Draghi, explicitly said that the ECB does not react to communications from other central banks, the fact is that market tightening emerged following the Fed's announcement of the exit strategy for its quantitative easing policy. Therefore, it cannot be ruled out that this new communication strategy may end up being more and more coordinated among central banks.

Separately, the Bank of England suggested at its monthly meeting in July that it would also be adopting a forward guidance strategy soon (although several analysts claim that this strategy already began implicitly on 4 July, when the Bank of England hinted that the markets had overreacted/misunderstood the Fed's plans).

However, the implementation of this new communication strategy does not imply that a new wave of unconventional measures will be adopted. In fact, in the case of the ECB, the comments made during the press conference after the monthly meeting in June have moderated market expectations in this regard. On the one hand, the central bank pointed out that wide debate is taking place within the ECB on the measures to be used to repair the monetary policy transmission mechanism: boosting LTRO (longer-term refinancing operations), reducing the deposit facility to negative territory and/or easing restrictions on eligible collateral. In relation to this last point, the ECB recently relaxed certain guarantee criteria required from banks when they request liquidity. But on the other hand, as regards new measures aimed at stimulating credit to SMEs and revitalizing the ABS (Asset-Backed Securities) market, the ECB has stated that "they would not be in the short term".

Under our baseline scenario, with the eurozone economy starting to recover in the second half of the year, rates are likely to remain at 0.50%, although the downward bias is maintained.

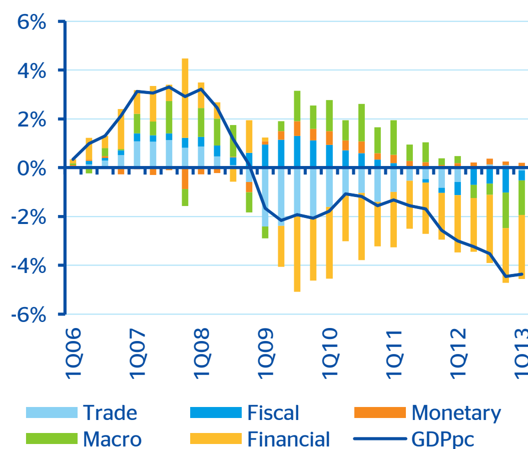
4. Eurozone economic outlook

The recession in the eurozone as a whole eased in 1Q13...

The GDP decline in the eurozone moderated in the first quarter (a drop of 0.3% q/q following a fall of 0.6% in 4Q12) due basically to the resilience of private consumption (0% q/q, compared with a fall of 0.6% in 4Q12) and with domestic demand proving less of a drag (of a negative 0.4pp following on from -0.7pp). The decline in global demand at the end of 2012 and the beginning of the year (in China and some other emerging markets and in the U.S.) had a negative effect on exports, which contracted for the second quarter in a row (down 0.9% q/q) and was also reflected in a sharper fall in investment (down 1.9% q/q after a fall of 1.5% q/q in 4Q12). However, as the need for intermediate products to meet external demand has declined and domestic demand weakened, there was a corresponding greater fall in imports (down 1.2% q/q), so the net contribution of exports to quarterly GDP growth remained at a positive 0.1pp.

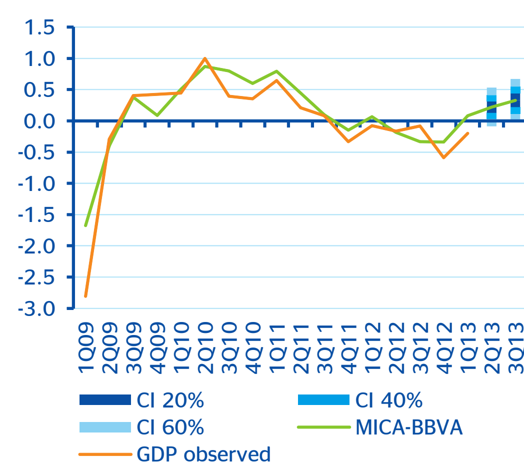
The decline in global demand, together with the negative impact of weather conditions at the start of the year, are the main reasons for the worse performance of the eurozone economy compared with our forecasts three months ago, which suggested the economy would have remained flat. The biggest negative surprises were in the core countries: GDP in Germany was up only 0.1% q/q (BBVA Research: 0.4% q/q, with the industrial sector feeling the effects of lower demand from abroad and construction hit by bad winter weather); in France it was down 0.2% q/q (BBVA Research: 0%); while the significant easing of the recession in the periphery was in line with our scenario: Italy down 0.6% q/q after a fall of 0.9% in 4Q12; Spain down 0.5% q/q after 0.8%in 4Q12; and Portugal down 0.4% q/q after a fall of 1.8% the previous quarter. Exports fell across the board in the eurozone member states (except in Portugal, where they increased by 2.6% q/q); although in the periphery the fall in exports was more than offset by an even bigger drop in imports. In fact, the factors behind this downward surprise are not as negative as could be thought at first sight, as they seem to be temporary (we still expect robust global growth). They would not therefore imply a substantial change in the underlying factors of the eurozone economy compared with what we expected three months ago, and they do not appear to reflect a contagion of the crisis from the periphery to the core countries, which was one of the main concerns at that time.

Chart 10
EMU; decompositon of GDP per working-age polulation (cyclical component)



Source: BBVA Research

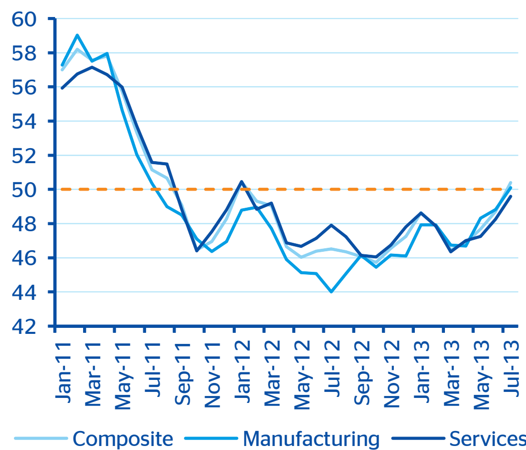
Chart 11
EMU: MICA-BBVA and observed GDP (% q/q)



Source: Eurostat and BBVA Research

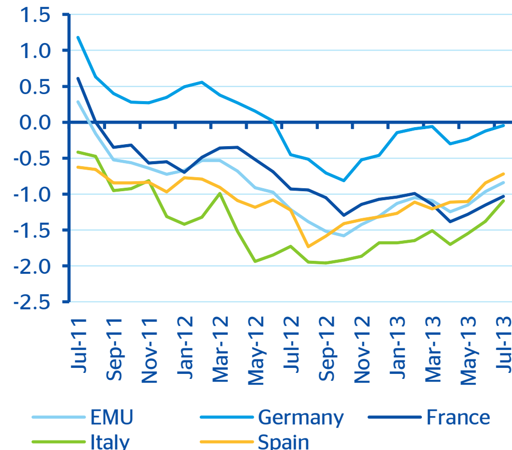
If we analyze the structural factors[2] behind the GDP contraction in 1Q13, we see a continued negative impact from financial shocks (basically in terms of a credit squeeze), although the fall in output was moderated by less negative impact from fiscal adjustment and an easier monetary policy; at the same time, support from net exports has reduced (see Chart 10), though we think that this is temporary, given our forecasts of a solid growth in the global economy in 2013 and 2014 (3.1% and 3.8%, respectively).

Chart 12
EMU: PMI Confidence Survey



Source: Markit Economics and BBVA Research

Chart 13
EMU: economic sentiment indicator (standardise)



Source: European Commission and BBVA Research

… and we still expect a slight recovery in 2Q13, led by Germany…

Taking into account all the available information for 2Q13 (quantitative data through May), our MICA-BBVA model[3] estimates GDP growth of around 0.2-0.3% q/q (see Chart 11), somewhat more optimistic than our estimate three months ago of a rise of 0.1% q/q. In addition, although uncertainly remains high, the probability of another fall in GDP in 2Q13 according to our model has fallen substantially to around 20%, from over 40% three months ago.

The confidence indicators surprised positively, particularly in May, suggesting an improvement in the economic situation, although they still remain low. In particular, the PMIs for the eurozone as a whole remained under the theoretical growth threshold, but appeared to hit a turning point in March this year. Since then, they have improved and returned to the levels observed at the end of 3Q11, when the economy was growing slightly. The improved confidence has been general across all the sectors, although more marked in manufacturing due to the support of still robust global demand (as anticipated by the upturn in industrial orders, above all from abroad), while the weakness of domestic demand continued to dampen expectations in the service sector (see Chart 12).

Confidence has shown particular improvement in peripheral countries (see Chart 13), which suggests the recession will ease further there in 2Q13 (as confirmed by advance GDP figures for some countries such as Spain), while in countries in the center of Europe the confidence indicators remained relatively stable. However, unlike the case in 1Q13, the confidence indicators could have been affected negatively by increased uncertainty in the periphery at the beginning of 2Q13.

2: According to our dynamic general equilibrium model. For a more detailed description of the model, see Europe Economic Watch, "*Bank lending and business cycle in EMU: a slow and fragile recovery*" in: http://serviciodeestudios.bbva.com/KETD/fbin/mult/Europe_Economic_Watch_190711_tcm348-263401.pdf?ts=1122011
3: For a detailed description of the model, see the working document "The Euro-Sting revisited: PMI versus ESI to obtain euro area GDP forecast", available on: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1120_tcm348-260444.pdf?ts=622013

In addition, economic activity data, mostly only available through May, show a more positive outlook than the soft indicators, suggesting there was quarterly GDP growth already in 2Q13. Retail sales to May (which increased by 0.3% on the first quarter) together with improved consumer confidence and some stabilization in unemployment (up 0.1pp to 12.2%) and the reduction in inflation (down 0.4pp to an average 1.4% in 2Q13) suggest that private consumption could have increased slightly in 2Q13 (up 0.1% q/q). Industrial output through May has picked up significantly by around 1% on 1Q13, following the standstill in the first quarter and the slump at the end of 2012. However, given the low capacity utilization (just over one standard deviation under the average), as well as what are still tight credit conditions, investment could have contracted again in 2Q13, although at a much more moderate rate (down 0.3% q/q after a fall of 1.9% in 1Q13).

Somewhat less positive signs have come from figures on the trade balance, showing that exports fell again in April and May, although not enough to offset the upturn in March, while the 3-month moving average rate (less volatile) continues to show an incipient recovery. At the same time, improvements in orders from abroad suggest that this situation should continue in the coming months. All the above, combined with the continued decline in imports, suggests that net exports would again have made a positive contribution in 2Q13 (up 0.2pp).

By countries, our models estimate that only the German economy would have picked up clearly in 2Q13 (up 0.5% q/q following a rise of 0.1% in 1Q13), due in part to the positive effect of the disappearance of temporary adverse effects from the two preceding quarters and the recovery in exports; while the French economy will have stagnated (following a fall of 0.2% in 1Q13); and the recession will have continued to ease in Spain (down 0.1% q/q after a fall of 0.5%), Italy (-0.3% q/q following -0.6%) and Portugal (-0.1% q/q from -0.4%) (see Chart 14).

… and in the peripheral economies in the second half of the year

The only confidence indicators available for 3Q13 are for July, so it is still early to draw clear conclusions. Both the PMIs and those published by the European Commission show a more upbeat outlook at the start of the quarter, with a general improvement in all the sectors and, more importantly, a general improvement that extends to the peripheral countries (see Charts 12 and 13). These figures are in line with our scenario. As well as already including a slight growth for the core economies and the eurozone as a whole in 2Q13, it suggests recovery will also begin to be observed in the periphery, above all toward the end of the year.

Economic policy decisions should try to prevent a derailment of the recovery

Over the last three months some of the conditions that supported growth have changed. First, global growth, which is key for emerging from the recession, is weaker than expected, and subject to a bigger downward bias. Also on the negative side, the banking union project is moving forward, but more slowly than originally planned. This clearly means it will be a supporting factor in the medium and long term, rather than offering an immediate solution for emerging from the crisis.

However, a series of positive factors emerged following the adoption of some economic policy measures. It is clear that fiscal policy will be less restrictive in 2013 and 2014, and this appears to be having a positive impact on the expectations of economic agents; while the dissuasion effect of the OMT program announced by the ECB in the summer of 2012 continues to have its effect. More recently, the ECB has reduced its interest rates (this was not necessarily discounted) and has above all surprised the market with a policy of shaping expectations and easing its stance.

Although it is difficult to weight up the relative impact of each of these factors, we assume in our forecasts that their combined effect on growth will be approximately neutral.

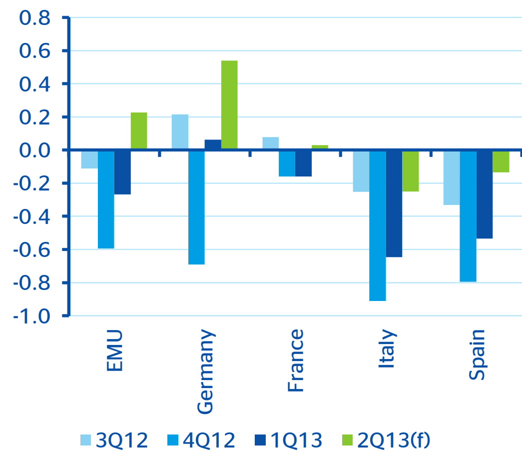
The economy will contract again in 2013 as a whole and grow slightly in 2014, but still below its potential

As explained above, the main surprise with respect to our forecasts three months ago was the more pronounced slowdown in global growth and its negative impact on the European economy, as well as the adverse effect of the harsh weather conditions in 1Q13. This negative growth surprise in the first quarter (down 0.3% q/q compared with the forecast positive growth of 0.1%) has dragged down our forecast made three months ago for 2013 as a whole by around 0.4pp.

However, this does not represent a significant change in the drivers underlying the recovery, which we still expect to begin in 2Q13. This is because, first, our short-term BBVA-GAIN model estimates a slight recovery in the global economy in the quarter (0.6% q/q after a slowdown by 0.1pp to 0.5% q/q in 1Q13) and our forecasts continue to include a robust global growth in the forecast horizon (3.1% in 2013 and 3.8% in 2014, compared with 3.3% and 3.9% respectively in our previous scenario), which will continue to support the recovery of the eurozone economy, particularly in the periphery.

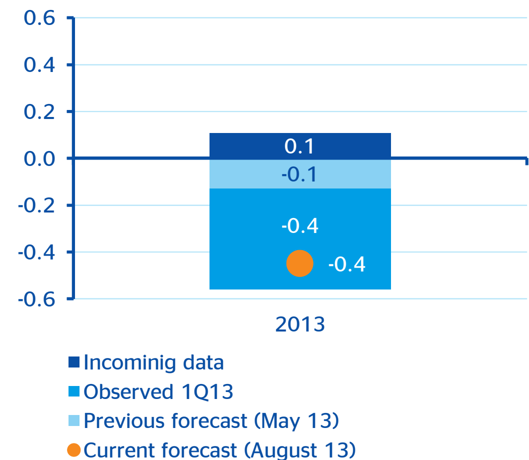
Second, the European crisis is being resolved, in general terms, in line with expectations. There has been a reduction of risks in the periphery, following the measures adopted last year (above all the OMT program), combined with the additional measures adopted by the ECB. These additional ECB measures should limit the recent rise in interest rates and help reduce the fragmentation of the financial markets, thus avoiding possible adverse effects from the somewhat disappointing measures taken in the process of creating banking union. Finally, the slower pace of fiscal consolidation in 2013 and 2014 should mean a reduced drag on recovery.

Chart 14
GDP growth (% q/q)



Source: Eurostat and BBVA Research

Chart 15
EMU: annual growth and factors



Source: BBVA Research

All these factors should be reflected in economic data for 2Q13 being better than expected three months ago, pointing to a positive quarterly growth in GDP for the eurozone as a whole of around 0.2% q/q in 2Q13, which would offset with a positive 0.1pp the negative drag from the worse economic performance in 1Q13.

In all, we have revised down our growth scenario for 2013 by 0.3pp to a negative 0.4% and maintain our forecast of moderate growth of around 1% for 2014 (see Chart 15), still far below potential. In fact, the GDP rate would still be around 1.5% below the pre-crisis level of 2007.

However, it is worth noting that these forecasts crucially depend on the management of the eurozone crisis over the next few months, and on certain external risks not materializing, such as a greater slowdown in the global economy, mainly in the emerging markets, and in particular China.

Our scenario assumes that the main factors behind the eurozone crisis will continue to fade away, although they are far from disappearing entirely. In particular, we are assuming that the European authorities will make continued progress toward banking union, which will help credit flows to the private sector of the economies in the periphery and lower the cost of finance. In addition, the member states, above all in the periphery, will continue with their process of fiscal consolidation and correction of imbalances on both the domestic and external front, so there will be no deterioration in the situation with respect to the markets. Overall, our scenario suggests that financial tensions will be in check, with some ups and downs, during the whole of the forecast horizon.

Incipient recovery in domestic demand in 2H13, but still dependent on the pull on investment from global demand

Given the slow correction and recovery of the determinants of domestic demand, for 2013 we expect that it will continue to weigh on economic growth (-1.1pp), although much less so than in 2012 (-2.1pp), as we expect an incipient recovery both in private consumption and investment in the second half of the year. In fact, in 2014 investment should consolidate its position and take over from net exports as the driving force for growth (0.8pp) (see Chart 16).

Private consumption already showed some resilience in 1Q13 after the sharp fall in 2013, supported by the reduction in the household saving rate (of around 1pp in 2012, due to the reduction in precautionary savings resulted from improved confidence) and more moderate inflation since 3Q12 (around 1pp), which will mitigate the fall in household disposable income. However, the private-sector deleveraging process will continue in the periphery. Together with restrictive financial conditions and low confidence levels, this makes us expect a slow and very gradual recovery in private consumption in the eurozone in the forecast horizon. Despite this, private consumption in 2013 as a whole will fall by around 0.4% (after a drop of 1.3% in 2012).

The weakness of private demand, combined with the slowdown in exports and greater spare capacity, will end up reflected in another contraction of investment in 2013 (down 3.6% according to our forecasts), though this figure is better than the drop of 4.2% last year. It will mainly be dragged down by the fall in spending on equipment goods and transport, while the reduction of investment in construction will still be mainly linked to the cut in public expenditure. However, our scenario includes an incipient recovery of investment in the second half of 2013, which will gain strength throughout 2014, once recovery in domestic demand is consolidated and doubts on global growth are dissipated.

The need to guarantee the sustainability of public finances, despite the relaxation of the fiscal targets in various member states being reflected in a lower fiscal effort, means that the limited room for fiscal maneuver will end up imposing a clearly procyclical trend in public consumption once more in 2013. Our scenario includes a slight contraction of 0.4% in public consumption. As a result, the public deficit for the whole of the eurozone could fall by 0.9pp to 2.8% of GDP this year, with an increase in the public debt to around 94% of GDP.

For 2014, our scenario forecasts a consolidation of the recovery in the whole of the eurozone, as many of the measures underway will have their effect on the real economy, although growth will still be under potential. Recovery in the core countries of Europe will gain strength this year and they will continue to grow above the average for the monetary union in 2014, supported by robust private expenditure and improved financing conditions. Meanwhile, although differences with the periphery will linger, they will gradually narrow. The reasons for this include, first, the structural reforms carried out in most countries in the periphery, which should lead to a swifter adjustment of the imbalances in the private sector and more flexible economies capable of supporting economic growth and an improved labor market. Second, the fiscal adjustment underway should result in improved public balances that reduce the risks of another sovereign debt crisis and thus a negative impact on the banking system. Combined with the restructuring of the banking sector in various peripheral countries, and progress toward banking union, this

should help restore credit to the private sector. Overall, we expect a general improvement in all the components of domestic demand in the eurozone, with growth in private consumption (0.6%) and investment (2.3%), without public expenditure being a drag on the GDP growth (0.3%).

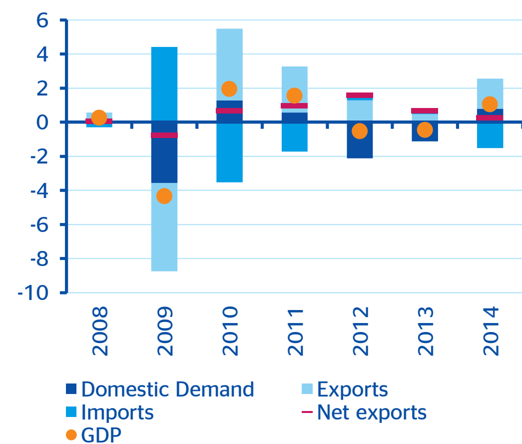
Net exports will continue to be the driver of growth in 2013, but will lose their relative importance in 2014

We have revised down our growth forecasts for exports in 2013 (1% from the 2.3% projected three months ago), due to the drop observed at the end of 2012 and the beginning of 2013. Nevertheless, they will continue to benefit from what is still robust growth in the global economy and a slight depreciation of the euro in the second half of this year and in 2014. As a result, they will be the main driving force behind recovery in investment in the short term. However, we now also expect a slight fall in imports of 0.5%, reflecting the reduced need for raw materials and intermediate goods to meet foreign and domestic demand. The result will be a significant positive contribution of net exports (0.8pp in 2013, compared with 1.6pp in 2012). In 2014, the rate of growth of exports will increase (3.8%) and help investment recovery, although the resurgence of imports (3.7%) will almost reduce the contribution of net exports to GDP growth (0.3pp) (see Chart 16).

The labor market will not improve until mid- 2014

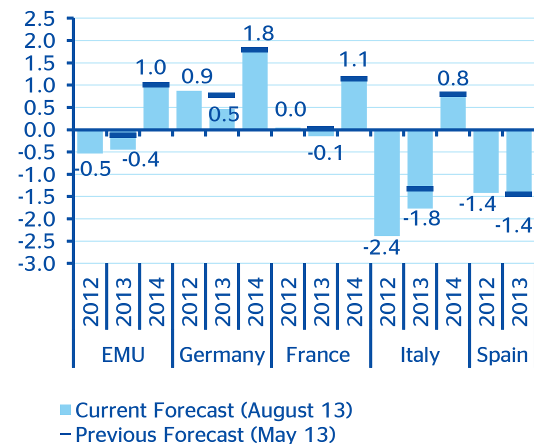
Given this scenario, and the time lag in the impact of growth on employment, our forecasts suggest that the labor market will continue to deteriorate in the coming quarters, although it will already give signs of stabilizing in the second half as job destruction levels off. However, this will still not prevent the unemployment rate from continuing to rise slightly. As a result, we expect a renewed fall in employment in 2013 (down 0.7%, the same figure as in 2012). This will be reflected in an increase in the unemployment rate of around 0.8pp to 12.2%. For 2014, despite the consolidation of economic recovery, growth will still be below potential, so our forecasts suggest a slow recovery in employment (0.1%) which will not be sufficient to reduce the unemployment rate (12.3%).

Chart 16
EMU: annual contribution to growth (pp)



Source: Eurostat and BBVA Research

Chart 17
EMU: growth forecasts by country



Source: BBVA Research

Recovery on track in the eurozone core, while in the periphery we will have to wait until the end of the year

Although the worse-than-expected economic performance in early 2013 was the result of temporary factors and not fundamental changes, as pointed out above, we have revised down our growth forecasts for 2013 as a whole, particularly in the eurozone core (see Chart 17). Despite this, our forecasts continue to envisage a recovery in activity starting in 2Q13, above all in Germany, and a standstill in France, while the peripheral countries will not begin to record even slightly positive GDP growth rates until the end of the year.

As a result, we continue to expect that only the German economy will grow this year (0.5%), at a lower rate than in 2012 (0.9%), due to the relative strength of the fundamentals of its domestic demand and still support of foreign demand.

In France, although the relaxation of fiscal targets will help growth, while the reduced uncertainty regarding economic policy will lead to improved confidence of the economic agents, domestic demand will continue to act as a drain on growth this year and offset the positive effect of net exports, resulting in a slight GDP contraction (down 0.1%).

The peripheral countries will have to continue to correct their economic imbalances and deal with the fragmentation of the financial markets, which makes their financing costs even higher. In general, political uncertainty has also increased in all these countries, given the impact that the strain caused by reforms (Greece and Portugal) and/or other political conditioners are having on the stability of national governments. For Italy, we now expect that the recession will be somewhat deeper in 2013 (growth down 1.8%), while we maintain our forecast that GDP in Spain will contract at a similar rate to 2012 (down 1.4%).

Our scenario does not include a return to general growth across countries until 2014, although there will continue to be differences between them: core economies will grow above the eurozone average of 1%, while growth for those in the periphery will be more moderate (see Chart 17).

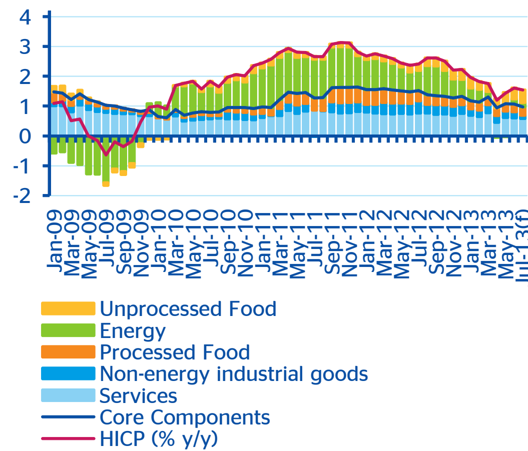
Inflation will remain clearly below the ECB's target over the forecast horizon

Inflation continued to slow in the second quarter of 2013 by 0.5pp to 1.4% y/y (as an average in 2Q13). This fall was somewhat steeper than expected, as there was not only a larger price moderation in energy prices, but core inflation also slowed by 0.2pp to 1.3% y/y. However, as we noted in our previous report, both headline inflation and core inflation picked up again in April and May to 1.6% and 1.3%, respectively, as a result of the base effect of more moderate energy prices in the same months of 2012, and the impact of the change in the date of Easter (see Chart 18).

In the second half of the year, we expect headline inflation to slow again, particularly starting in August, and to hover at around 1.3% y/y for the rest of the year. Core inflation should remain relatively stable at current levels (1.3% y/y) in the second half of the year. As a result, we now expect that both headline and core inflation for 2013 as a whole will be at 1.5% and 1.4% respectively (0.1pp down on our forecast three months ago in both cases) (see Chart 19).

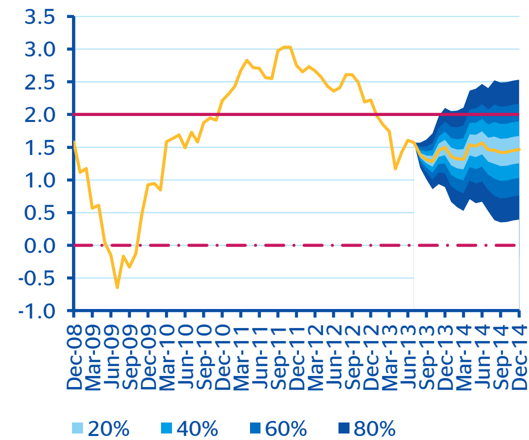
For 2014, inflation should remain relatively stable, given the lack of inflationary pressure on both the demand and supply side, particularly given that the relaxation of the fiscal targets in some countries makes the chance of new tax hikes less likely over the forecast horizon, and that the improvement in the labor market will be very gradual. Overall, although uncertainty on some exogenous variables (commodity prices) and/or discretionary variables (administered prices, taxes) continues high, the risks for this inflation scenario are balanced.

Chart 18
EMU: Contribution by components to annual HICP inflation (% y/y)



Source: Eurostat and BBVA Research

Chart 19
EMU: HICP inflation (% y/y)



Source: Eurostat and BBVA Research

Both idiosyncratic and external risks are tilted to the downside

The measures announced at European level in the second half of last year have been effective in containing the crisis of the eurozone, as can be seen by the limited impact of the focal points of tension in some countries of the monetary union during the first half of the year (the banking crisis in Cyprus, political instability in the periphery). Nevertheless, uncertainty remains regarding whether the reforms in individual countries and the European institutions are moving forward at sufficient speed to take advantage of the window of opportunity provided by relatively calm financial markets.

Despite this calm, our forecasts continue to have a downward bias. This is because risks remain of financial tensions increasing again in the periphery for many reasons. One of the most plausible would be the weakening of governments and social protests, basically in the wake of the major adjustments underway. These could undermine the stability of their governments and thus of the economic policies that have to be implemented. The increased uncertainty about the sustainability of the economic measures announced could trigger a resurgence of the sovereign debt crisis, although we think that this risk is relatively minor. And all this in a context in which the process of moving towards a banking union still needs agreement and implementation processes rather complex.

At the same time, the risks from outside the eurozone have increased. A possible disorderly exit from the unconventional monetary policy measures in the U.S. could lead to higher interest rates and higher risk aversion. This would have an impact in terms of tighter financial conditions at a global level, with a major negative impact in those economies that are most dependent on capital inflows in the short term to finance their external imbalances (such as the European periphery). This risk is also relatively contained, as the authorities have learned the lessons from the communication problems linked to the monetary policy exit in the U.S.

In addition, and perhaps most importantly, the slowdown in emerging markets, in particular China, increases the risk of limiting the support provided by global demand, mainly because of the policymakers' dilemma regarding the main thrust of economic policy: they are now more concerned with avoiding excessive credit growth and thus have less room for maneuver to support growth, above all since the authorities appear prepared to tolerate growth that is slightly below target.

Eurozone member states: detailed analysis

Germany: recovery based on the strength of domestic fundamentals, although external factors could hamper growth

GDP: +0.5% in 2013   +1.8% in 2014   HICP: +1.7% in 2013   +1.8% in 2014

Latest official figures for 1Q13: the slight GDP growth recorded at the beginning of the year (+0.1% q/q) confirmed that the sharp contraction of activity observed in late 2012 (-0.7% q/q) was in part due to temporary factors, although some of these (a slowdown in global demand) did not recover as quickly as expected three months ago, while adverse weather conditions also had an impact, which led to a decline in construction (50% of total investment) of -2.1% q/q. Nonetheless, the resilience of domestic factors was reflected in a rebound in private consumption (+0.8% q/q, after -0.3% in 4Q12), supported by a strong labour market, which allowed domestic demand to have a positive impact on GDP growth (+0.1pp), offsetting a sharp decline in investment (-1.5% q/q), while public consumption was largely stagnant (-0.1% q/q). Moreover, the rest of investment also contracted slightly (around -0.4% q/q, after reaching -0.7% q/q), partly reflecting lower foreign demand and resulting in a drop in exports (-1.8% q/q, following -2.4% in 4Q12). However, the sharper decline in imports (-2.4% q/q, linked partly to a heavy drop in investment), was the result of a nil contribution from net exports.

Estimates for 2Q13: the most recent figures indicate that German growth rallied significantly in 2Q13 (BBVA Research: 0.5% q/q), once the aforementioned temporary factors have gradually disappeared. Firstly, the production index for the construction rallied firmly in April, following declines in previous months (-2.6% q/q in 4Q12 and -2.8% q/q in 1Q13), while, despite a correction in May, production in the sector was up significantly in the two months, by around 3% over 1Q13. Secondly, exports up to May again showed signs of improvement, exhibiting a growing trend already in March and April (around +1% 3m/3m), following a drop in late 2012 and the beginning of the year, mainly driven by exports to non-single currency European countries, as well as to the US and Asia, which offset a worse performance from purchases made from the eurozone and OPEC countries. Furthermore, industrial orders to May indicate that this should be sustained in the forthcoming months. However, confidence indicators showed less positive signs, not pointing to any significant improvement in orders from abroad, but instead suggesting that improving expectations in the industrial sector are based on increasing domestic orders. Regarding the latter, both soft and hard indicators point in the same direction. Consumer confidence continued to improve, supported by a strong labour market and better prospects for future income, again showing an increase in retail sales up to May, which suggests that private consumption is still growing at strong rates. These improved expectations have already been reflected in a significant increase in industrial output up to May (+2.4%, after stagnating in 1Q13 and contracting -2.6% q/q in 4Q12), which along with low financing costs and increased capacity use at companies, should now lead to an increase in investment. Finally, although the data available for 3Q13 is highly limited, if we look only at confidence data for July, the figures suggest that the economy will grow at a strong rate in the second half of the year (+0.5% q/q), with widespread improvement for both manufacturing and services.

Growth prospects for 2013 and 2014: our forecasts again point to a strong recovery for the German economy over the next two years, based on improved domestic demand, particularly private sector spending, which should take over from exports. However, the slump in activity recorded in 4Q12, along with a poor performance in the economy in 1Q13 leads us to slightly revise downward our growth estimates for the full-year 2013, by -0.3pp to +0.5%, while we leave our 2014 forecast unchanged at +1.8%. The sustained improvement in the labour market, growing salaries and moderate inflation should lead to faster growth in household consumption in 2013 and 2014 to 1.1% and 1.4%, respectively. Better expectations for domestic demand and the resilience of emerging economies, along with low financing costs, should be enough to support a bounce in investment, particularly in 2014 (4.1% following -1.1% in 2013). Furthermore, the restructuring of public finances should allow for neutral fiscal policies. The recovery in domestic demand should trigger greater dynamism from imports, which would mean eliminating the contribution to growth from net exports (-0.1pp in 2013 and 0pp in 2014, after 1.1pp in 2012).

Prospects for inflation: in 2Q13 as a whole, both headline and core inflation slowed again, by 0.2pp and 0.1pp to 1.6% y/y and 1.2% y/y, respectively. However, this performance was the result of a sharp slowdown in April, caused mainly by Easter falling in a different period compared to 2012, although it once again picked up in May and June, albeit with core inflation holding at moderate levels (1.4% y/y), in line with forecasts. Over the forthcoming months, we expect core inflation to rise again slightly. This is due to increased domestic demand and also because higher labour costs will be somewhat passed onto final prices, which will be offset by lower inflation in energy and food. As a result, we expect average annual inflation to fall in 2013 by 0.4pp to 1.7%, remaining relatively stable in 2014 (1.8%), while steading above the eurozone average inflation in both years (1.5% in 2013 and 1.4% in 2014).

Public sector: having achieved a fiscal surplus in 2012 (0.2% of GDP) that was better than forecast by the government, our forecasts point to balanced public finances this year, again better than the deficit of half a point of GDP included in the government's stability program, which will allow for neutral fiscal policies that should let the recovery progress unhindered. In 2014 we expect a slight surplus (0.2% of GDP). As a result, public debt could begin to come down slightly this year to stand somewhat below 80% of GDP by the end of the forecast horizon.

France: postponing fiscal reforms will help the recovery gain traction, although it will not prevent the economy from shrinking slightly in 2013

GDP: -0.1% in 2013 +1.1% in 2014 HICP: +1.1% in 2013 +1.3% in 2014

Latest official data for 1Q13: the French economy faced the same restraints as in 2012, with continuous deterioration of domestic drivers (deterioration of the labour market, decline in confidence and uncertainty regarding economic policy), which was again reflected in another fall in private sector spending (with a drop in private consumption of -0.1% q/q and in investment of -1% q/q). In particular, deteriorating confidence among the economic agents led to an increase in the saving rate (to 16%), despite disposable income rebounding sharply early in the year (+1.3% q/q, following a decline of -0.7% q/q in 4Q12, due to one-off taxes), while the increase in corporate profits (+0.9% q/q) failed to fuel investment. However, all of the above was offset by relatively stable growth in public consumption (+0.4% q/q) and an increase in inventory stock (+0.2pp, following the strong destocking observed in 2012), which led to nil contribution from domestic demand. The restoration of inventories was reflected in greater dynamism from imports (+0.2% q/q, after -1% in 4Q12), while exports contracted again, although at a slower rate (-0.4% q/q, following -0.7% q/q in 4Q12), therefore removing the slight support provided by net exports throughout most of last year, deducting 0.2pp from quarterly GDP growth in 1Q13. In summary, GDP contracted again by -0.2% q/q early in the year, which was more than anticipated (BBVA Research: 0%; Consensus: -0.1%), being the negative surprise widespread to both, components of domestic and foreign demand, although our previous publication did emphasize the downward bias in our previous forecast.

Estimates for 2Q13: the latest figures (confidence, particularly as of June, and hard data to May) suggest that the economy may already have grown slightly in 2Q13, which would point to an upside bias in our forecasts for stabilization. On the one hand, confidence indicators, after showing disappointing levels in March and remaining stagnant at very low levels early in the quarter, improved significantly in June and July, with this improvement coming across all sectors and suggesting an underlying slight improvement in domestic demand. In particular, retail sales up to May once again grew (+0.8% on 1Q13, following -0.2% q/q), partly underpinned by lower inflation and some stabilization in the labour market, which suggests that, while still weak, private consumption may have grown slightly this quarter. On the other hand, industrial output up to May also rallied significantly (+1.9% after -0.2% q/q in 1Q13), showing more evidence of dynamic activity levels, although we do not expect an immediate impact on investment. Although confidence surveys show a gloomier picture for purchases from abroad, the trade balance figures indicated a clear rally in exports to May (2.5%), which could again result in a slight positive contribution from net exports. Finally, confidence figures for July again showed a positive surprise, pointing to consolidation of the recovery in the second quarter of the year, in line with our forecasts (around 0.2% q/q).

Growth prospects for 2013 and 2014: the decline in GDP early in the year, compared with the stabilization in activity that we were expecting, has led us to slightly lower our 2013 forecast by -0.1pp to -0.1%, with our forecast still pointing to slight growth in the second half of the year, as we expect factors underlying domestic demand to stabilize in the coming quarters. In particular, our projections suggest that economic agents' confidence will continue to improve, as the postponement of fiscal reforms will help reduce uncertainty over adopting additional fiscal measures in the short term, and therefore will not negatively affect either consumers' disposable income (which will also benefit from moderating inflation) or corporate profits, which will be reflected in increased investment and a stabilized labour market. Therefore, private consumption will shrink slightly in 2013 (-0.2%, after -0.3% in 2012), to grow somewhat more than +0.5% in 2014. This improvement in domestic demand will be reinforced by faster exports growth over the year, and along with low financing costs will end up driving investment, which should rally in 2014 after the drop projected this year (-2% in 2013 and +2.2% in 2014). The gradual improvement in domestic demand (-0.4pp in 2013 and +1pp in 2014), also supported by growth in public consumption (+0.8% in 2013 and +0.6% in 2014), will lead to further growth in imports in 2014 (after stagnating in 2013), with the positive contribution from net exports disappearing (+0.2pp in 2013 and +0.1pp in 2014, after 1pp in 2012).

Inflation prospects: headline inflation continued to decelerate, around -0.3pp to 0.9% y/y in 2Q13 as a whole, although at a slightly slower rate than in previous quarters (-0.5pp both in 4Q12 and 1Q13, from 2.4% y/y since mid-2012). Unlike other member states and the eurozone as a whole, following the sharp slowdown in April (due to moderating prices for core components and, to a lesser degree, energy), the increase was much more moderate in subsequent months, with inflation rates (1% y/y headline inflation and 0.7% y/y core inflation in June) well below the eurozone average (1.6% and 1.3%, respectively), which was the result not only of more drastic deterioration of domestic demand, but also of the absence of fiscal measures that could have affected consumer prices. Given the anticipated economic scenario, inflation will remain relatively stable over the next few months, which could lead to an average annual inflation rate of 1.1% in 2013 and 1.3% in 2014.

Public sector: After the fiscal deficit target was eased to 3.9% of GDP in 2013 (+0.2pp against the figure announced by the government, which had already been revised from 3%), fiscal consolidation has been eased by around +0.5pp of GDP to 1.4% in 2013. According to our scenario, the cyclical deficit will stand at 1.6% and the structural deficit at 2.3%. Budget execution data so far suggests that the target will be reached, also in line with our forecasts.

Italy: net exports will support the timid recovery expected by the end of the year, leading to moderate growth in 2014

GDP:-1.8% in 2013 +0.8% in 2014 HICP: +1.6% in 2013 +1.7% in 2014

Latest official figures for 1Q13: the recession eased early in the year (-0.6% q/q, after -0.9% q/q in 4Q12), although somewhat less than anticipated (BBVA Research: -0.3% q/q; Consensus: -0.4% q/q), due mainly to the disappearance of the support provided by net exports (-0.1pp, following +0.6% q/q during 2012 as a whole). The positive reading is that the lower drop in activity levels was caused by slower deterioration of domestic demand (-0.5pp, following -1.2pp in Q412), supported by a more moderate contraction of private consumption (-0.5% q/q, following -0.8% q/q in 4Q12), while public consumption did not undermine activity levels (0.1% q/q), reflecting the easing of fiscal targets. Domestic demand, which remains depressed, along with deterioration of foreign demand, continued to negatively affect corporate profits (-0.9% q/q, following -2.7% in 4Q12), which along with more restrictive financial conditions again dragged down investment (-3.3% q/q, after -1.8% q/q in 4Q12), without yet showing signs of stabilization. Finally, following inventory adjustments in the two previous years, the positive contribution registered in the first quarter (+0.3pp) helped offset all of the above.

2Q13 estimates: Confidence surveys show mixed signals. On the one hand, the improvement in European Commission indicators points to a more restrained decline of GDP, although PMIs were significantly higher than expected in April, showing a more pronounced improvement for the full quarter, particularly for the industrial sector (better expectations of foreign orders, although this still has not yet been seen in industrial output data up to May), while the bounce from the services sector was more moderate (reflecting weak domestic demand). In general, the available data suggests that the decline in activity will have slowed again, in line with our forecast of GDP contracting -0.3% q/q, underpinned by some resilience from private consumption and, again, by the positive contribution from net exports. On the one hand, inflation has declined significantly since late 2012 (-0.8pp in 4Q12, -0.6pp in 1Q13 and -0.8pp in 2Q13) and will continue to drive up real disposable household income (+0.5% q/q in 1Q13, after registering a drop of -4.8% in 2012), although at a moderate pace given the ongoing deterioration of the labour market. This is already showing in the retail sales figures available up to May, with a clear slowdown in the decline of household spending over the previous two quarters. All of the above suggests that private consumption should again be a bit more resilient in 2Q13. On the other hand, trade balance figures suggest that net exports have again helped positively to the moderation in the decline in GDP, largely thanks to further contraction in imports, as there is yet to be a clear improvement in exports, despite the support from orders coming from outside of the European Union. However, a rebound in industrial orders, also from the aforementioned economies, points to a sustained improvement in exports over the next few months, which seems to be the only driver of growth in the short term. Above all because the timid improvement in exports will not be enough to boost investment over the rest of the year, given the ongoing deterioration of corporate profits along with unused capacity at companies and high financing costs.

Growth prospects for 2013 and 2014: Timid signs of improvement are expected in the second half of the year, with the economy stagnating in 3Q13 and growing slightly in 4Q13, with a slight recovery coming next year. Given the sharper than anticipated contraction of GDP early in the year, the GDP forecast for 2013 as a whole has been revised downward, with our current forecast being a -1.8% decline. The forecast for 2014 remains unchanged (+0.8%). By components, in 2013 domestic demand could contribute -2.8pp to the GDP performance, as a heavy decline in investment is expected (-6.4%), but also in private consumption (-2.4%) and public spending (-1%). As for foreign demand, a positive contribution of 1pp is expected this year, mainly due to a drop in imports, while exports are set to remain stagnant. As regards domestic demand next year, the trend is expected to shift in nearly all components, particularly investment, which is forecast to show growth of +0.7% following the sharp decline this year. The strength of domestic demand in 2014 (+0.1pp) will mean an increase in imports that will undermine the positive contribution from net exports (+0.6pp). However, there are risks that may undermine our growth estimates, linked to the political context and, therefore, the implementation of fiscal and structural measures aimed at rekindling investor confidence.

Inflation outlook: As we anticipated three months ago, inflation eased significantly over the second quarter, particularly headline inflation, due to a drop in energy prices. Specifically, inflation has come down by around -2.3pp since mid-2012 to 1.4% y/y in June, while core inflation declined -1.3pp to 1.2% y/y, as the positive impact from tax increases in late 2011 disappeared. Given the weakness of domestic demand, we expect inflation to remain relatively stable over the rest of the year, with an average annual inflation of 1.6% in 2013. In 2014 the incipient recovery of domestic demand and a weak labour market will keep pressure off prices, with average annual inflation expected to stand at 1.7%. However, these forecasts are subject to uncertainty regarding potential tax hikes linked to fiscal consolidation.

Public sector: The deficit target established for 2013 (2.9% of GDP) has been revised upward from the 1.7% announced at the start of 2012. This revision is mainly due to worsening growth estimates and the inclusion of the impact of the government's debt payments (valued at 2.6% of GDP). This involves a minimal structural adjustment, which should have no impact on activity levels over the rest of the year. Budget execution data show a cyclical deterioration, as do our forecasts, which now point to a budget shortfall of around 0.2pp, with the deficit reaching -3.1% of GDP. Furthermore, there is the risk of further budget deviation if a VAT hike is not implemented and the suspension of taxes on first home ownership is not scrapped, or if these steps are not offset by equivalent budgetary measures.

Spain: the recession is bottoming out, with recovery coming in 2014[4]

GDP:-1.4% in 2013 +0.9% in 2014 HICP: +1.7% in 2013 +1.1% in 2014

Latest official figures for 1Q13: following a sharp GDP decline in late 2012 (-0.8% q/q), the recession eased over the first months of the year (-0.5% q/q), due mainly to less contraction of domestic demand (-0.7pp, following -2pp in 4Q12), particularly private consumption, shaped by the base effect of a VAT hike and the scrapping of the December bonus pay for public servants on 4Q12 consumption. Meanwhile, the decline in investment in machinery and equipment was also curbed, thanks to increased goods exports, following the temporary setbacks in late 2012, which in any case confirms consolidation of net foreign demand as a buttress for the recovery. However, a shrinking decline in imports meant a decrease in the contribution from net exports (0.1pp).

Estimates for 2Q13: with detailed results yet to be released, preliminary GDP estimates indicate that the Spanish economy contracted -0.1% q/q, somewhat less than anticipated early in the quarter (BBVA Research: -0.3% q/q). As for the composition of growth, partial indicators posted to date point to slower contraction of domestic demand (contributing to the GDP decline of -0.6pp). The deterioration of household consumption continued to slow, due mainly to real disposable income eroding at a slower rate, improved net financial wealth, an anticipated decline in the saving rate and the Efficient Vehicle Incentives Program. Likewise, investment in machinery and equipment showed a trend shift in 1Q13, which seems to have been consolidated thanks to the strength of foreign demand and less weakness from domestic demand. However, residential investment continues its adjustment process, as has public consumption. Finally, in the second quarter there was a recovery in overseas sales, with a +0.5pp contribution to quarterly growth. Looking ahead to 1Q13, the available information points to the start of an expansive stage in the cycle, which will be shaped by a gradual recovery (MICA-BBVA Research: between 0.0% and +0.1% q/q).

Growth prospects for 2013 and 2014: the fundamentals of the Spanish economy should lead to a return to growth over the next few quarters, although not enough to prevent GDP contracting in 2013 as a whole by about -1.4%. In 2014 activity levels will grow +0.9%, given a gradual improvement in the international backdrop and the near completion of some domestic adjustments. Although these forecasts do not represent any changes against the growth figures announced three months ago, it is worth pointing out that they do include a slight downside revision of foreign demand (due to lower anticipated global growth), and an increase in domestic demand and employment (thanks to less weakness in the first half of the year). All of which affirms our diagnosis for the underlying performance of the Spanish economy: after nearly five years the financial crisis is bottoming out, paving the way for a classic recovery trend in 2014.

Inflation outlook: in 2Q13 headline inflation was down -0.9pp on average to 1.7% y/y. This performance mainly corresponds to a slowdown in energy prices, which even had a negative contribution on the annual change in consumer prices between April and May. However, core inflation was also down last quarter (0.3pp on average to 1.9% y/y) and contributed 0.2pp to the aforementioned performance. Going forward, despite the recent increase in special taxes (tobacco and alcoholic drinks) and regulated prices (electricity), inflation is expected to moderate further, at least over the rest of this year and the first half of 2014, following the exhaustion of the base effect triggered by tax reforms in 2H12. While there is still significant uncertainty regarding imported inflation (commodity prices), we are yet to see inflationary pressure on demand. Thus, average inflation this year will be around 1.7%, while the inflation forecast for 2014 is 1.1%.

Public sector: the results of budgetary execution to date reflect the significant fiscal reforms being introduced in structural elements. In 2013 as a whole, although we expect fiscal adjustment policies to continue, it is unlikely that these will be sufficient to offset the negative effects of a slump in economic activity on revenue and public spending and the expected increase in debt interest payments. BBVA Research forecasts suggest that in 2013 the economic cycle will drain nearly 1pp of GDP from expected revenue, affecting both taxes on output and taxes on income, and absorb their structural improvement. In short, bearing in mind both the announced and/or implemented measures, the deficit in 2013 will be around 6.5% of GDP (after 7% in 2012), in line with the new stability target approved by the European Commission at the end of May. This easing of stability targets will also ensure that the country is able to meet the official target approved for 2014, when the public deficit will stand at around 5.8% of GDP, as both the economic cycle and the structural improvement of revenue and spending begin to correct the fiscal deficit.

4: For further details, see Spain Economic Outlook 3Q13 in www.bbvaresearch.com

Box 3. Portugal: the economic outlook continues to improve

Following confirmation of our forecast of a less steep decline in GDP in the first quarter of the year, fuelled mainly by foreign demand, the latest real and confidence figures suggest that moderation will continue in 2Q13, and we could finally see positive growth rates by year end.

On the political front, the crisis in July resulted in a new executive formed by the same two parties that made up the former coalition. The policy aimed at complying with the Troika's program will presumably continue and will attempt to be compatible with a strategy of greater support for growth, still to be defined. The change of government has revealed a certain fiscal fatigue in Portugal, which could jeopardize the country's return to the markets in mid-2014, as shown by the sovereign spread levels (480 basis points at the end of July compared to nearly 600pp with the Government crisis).

The confidence data continues the recovery path…

The confidence surveys and leading indicators have continued to recover following the lows seen at the end of 2012 (see Chart 20). Consumer confidence from the European Commission in 2Q13 was slightly above the values seen in 1Q13 (an average of -53.8 in 2Q13 compared to -55 in 1Q13), although it is still below the historical average (-37.9). Likewise, the economic sentiment indicator continued to recover in 2Q13 (reaching an average of 84 points compared with 81 in 1Q13), coming increasingly close to its historical average (93.4) after the low levels observed at the end of 2012 (78 points). The soft data available for 3Q13, which is limited to July, suggests that this recovery could be consolidated in the coming months.

… as well as economic activity

The better performance is also reflected in hard data (see Charts 21 and 22). Industrial output up to June once again increased by 2% q/q, easing somewhat compared to the previous quarter, but already suggesting some recovery in the industrial sector after the strong decline registered at the end of 2012. However, given the low capacity used by companies and the restrictive credit standards, our forecasts still do not anticipate a significant impact on investment. In addition, retail sales also grew again over the quarter (+0.9% q/q) and, although they slowed down somewhat compared to 1Q13, they suggest that the moderate fall in household consumption will continue for the rest of the year. Finally, the fiscal consolidation underway will be reflected in a new decline in public spending.

Foreign demand support remains

The reduction of the trade balance deficit continued in the first two months of 2Q13. The accumulated deficit for April and May is down -2.9% compared to the accumulated figure for January and February (down -30% compared to April-May 2012) (see Chart 22).

Although it is true that both exports and imports have clearly recovered from the values registered at the end of 2012, the performance of exports is the main reason for the reduction of the trade deficit (up +3.5% m/m, accumulating up to May a +9% increase over 1Q13). The increase in imports is being much more moderate (+0.8% m/m in May, accumulating an increase of around +7% in relation to the previous quarter), suggesting that net exports will be the main driver of the moderation forecast for GDP.

Our MICA-BBVA model estimates that the moderation of the downturn will continue in the second quarter

Taking into account previous information, our MICA-BBVA model estimates that GDP in 2Q13 will contract by between -0.1% and -0.2% q/q, thus moderating the economic contraction one more quarter (see Chart 23).

In general, the Portuguese economy has behaved in line with expectations so far this year, with no significant changes in the main drivers underlying its economic performance. We therefore maintain our forecasts for 2013. We still expect the recession to ease (-2.3% after the -3.3% reported in 2012) for the year as a whole, with a slight growth of the economy in the second half of the year, which should consolidate throughout 2014 and which will result in economic growth of around +0.5%.

The only support behind this moderation will continue to be the significant positive contribution from net exports, although the lower contraction of domestic demand should also help. The latter will be the result of a lower decline in private consumption, reflecting improved consumer confidence, and in investment, driven mainly by strong foreign demand. However, the major fiscal adjustment underway will continue to depress the economy over the forecast horizon. We expect this pattern to continue in 2014.

The budget execution data suggests that the new deficit target will be met

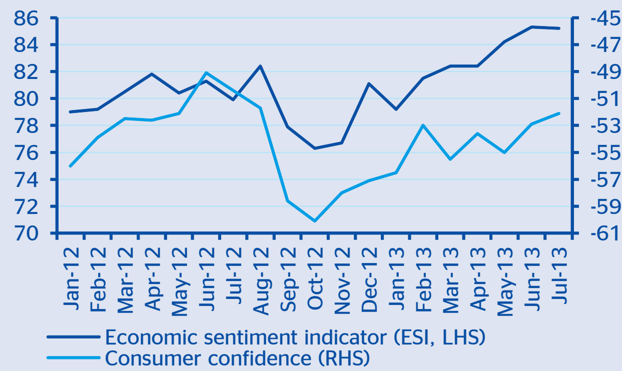
After the seventh evaluation by the Troika, the need for not over-adjusting public balances became clear, when the reason for non-compliance is mainly a worse-than-expected cyclical situation. After this change, the European Commission accepted a target review for 6

countries, including Portugal, which was later confirmed by the Ecofin. The targets were changed from 4.5% to 5.5% of GDP for 2013 and from 2.5% to 4% of GDP in 2014, and a 2.5% target was set for 2015.

However, this review practically left the fiscal consolidation needed to meet this year's target (which remains at around 3.6% of GDP) unchanged, since the new target simply tries to adjust to worse-than-expected economic performance.

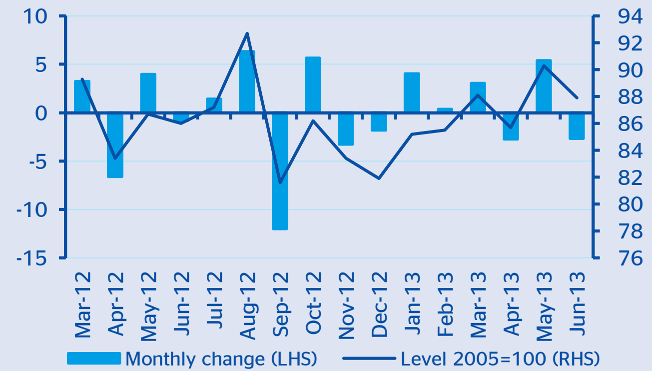
The budget execution data, available for January-May, shows that Portugal will meet the target set by the economic and financial aid program (5.5% of GDP) (see Chart 24).

Chart 20
Soft indicators from the European Commission



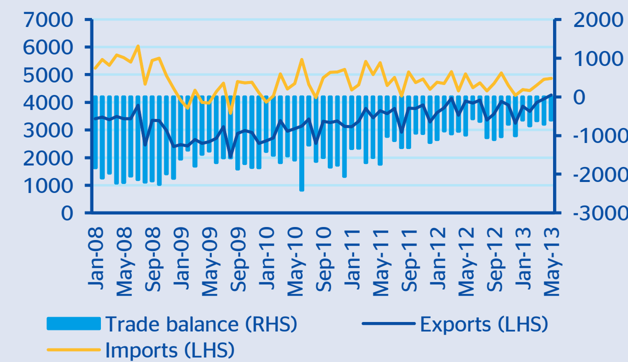
Source: European Commission

Chart 21
Industrial production (seasonally and working day adjusted)



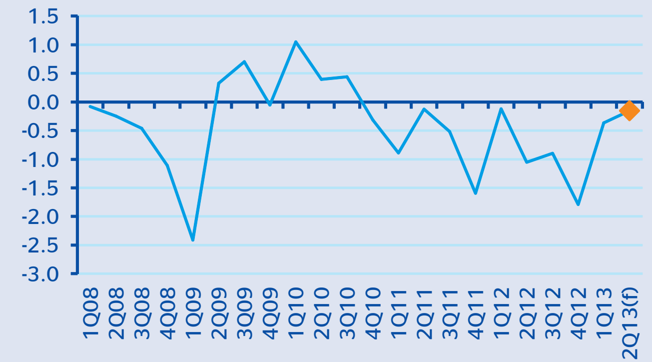
Source: INE and BBVA Research

Chart 22
Trade balance (€ million)



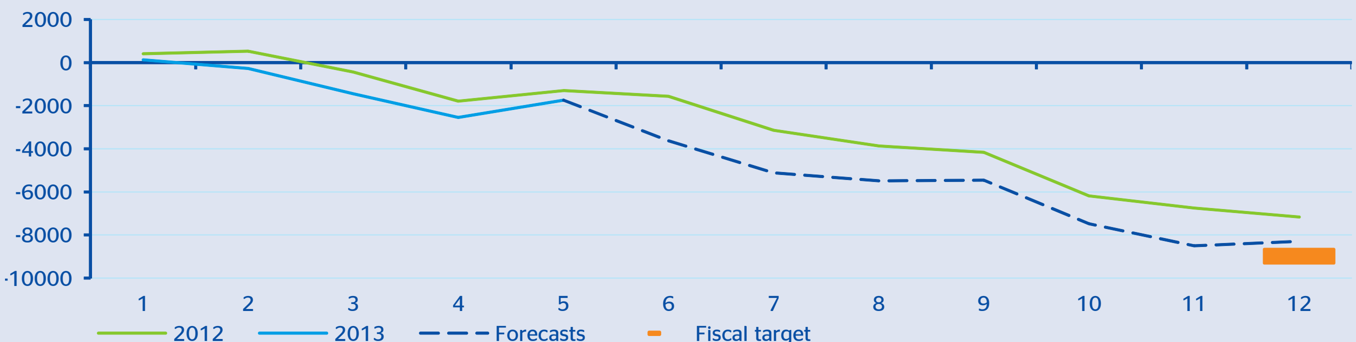
Source: INE and BBVA Research

Chart 23
MICA-BBVA and observed GDP (% q/q)



Source: INE and BBVA Research

Chart 24
Public deficit (mm €)



Source: BBVA Research

Box 4. United Kingdom: consolidation of recovery with a more balanced growth pattern

The economy already showed signs of recovery in 1Q13, but without dispelling the uncertainty about its sustainability…

GDP grew +0.3% q/q in the first quarter, as we expected, but higher than consensus (BBVA Research: +0.3%; Consensus: +0.1%), after contracting -0.2% in 4Q12. However, this upturn in activity did not clear up the doubts about whether the recovery was on the right track, mainly for two reasons. Firstly, due to the volatility of activity following the impact of the Olympic Games last year and secondly because the composition of growth did not reflect a sustainable pattern. The strong contribution from net exports (+0.6pp) reflected a significant decline in imports (-2% q/q), while the weakness of exports continued (-0.1% q/q). Despite the fact that investment remained practically stagnant (+0.2% q/q following -4.9% in 4Q12), it only reacted to the rebound in investment in construction (+13.4% q/q), supported by the public measures underway (the Help to Buy and Funding for Lending programs, FLS), while the rest of investment, both private (-1.9% q/q) and public (-6%), once again contracted as a result of weak foreign demand. The worsening of expectations on future demand in the second half of last year was also reflected in a strong reduction in inventories (-0.8pp). The robustness of private consumption (+0.5% q/q after +0.4% q/q in 4Q12) was not enough to prevent domestic demand from detracting -0.3pp from quarterly GDP growth (see Chart 25).

… although the flash GDP estimation for 2Q13 confirms stronger growth

Growth in the second quarter of the year was +0.6% q/q, slightly more than expected (BBVA Research and Consensus: +0.5%). This higher growth compared to the start of the year is due to widespread improvement across sectors, especially in construction, which grew +0.9% q/q after contracting -1.8% q/q in 1Q13, while industrial output also grew (+0.6% q/q from +0.3%). But the positive sign again was that growth was underpinned by the robustness of the services sector (+0.6% q/q after +0.5%), which accounts for around 75% of GVA and contributed approximately +0.5pp to quarterly growth.

The most recent indicators point to more balanced growth…

Although the GDP breakdown on the demand side is not yet known, the available indicators for 2Q13 suggest that domestic demand has once again supported growth (+0.3 / +0.4pp), due above all to the relative strength of private-sector spending, while the prop provided by public consumption will disappear totally (after +0.1% q/q in 1Q13), although the fiscal adjustment will not act as a drag on growth.

On the one hand, despite the fact that the labor market is still not reflecting the improvement in activity seen so far this year (with the unemployment rate stable at around 7.8% over last year) and it is likely that it will only improve slightly within the forecast horizon (after the crisis we expect the increase in working hours weighs on job creation), consumer confidence continued to improve, which has resulted in households offsetting the decline in disposable income (-1.7% q/q in 1Q13) with a reduction in the saving rate (-1.7pp in 1Q13 and around -3pp since 4Q12), as we already observed in 1Q13. The most recent data also shows increased growth in retail sales up to June (+0.9% q/q on 2Q13 from 0.5%), suggesting that private consumption should have continued to grow at a robust rate, similar to that recorded in previous quarter (+0.5% q/q).

On the other hand, industrial output up to May once again continued at a pace similar to the one seen at the start of the year. This combined with the increase in the capacity used by companies, the significant disinvestment in inventories, the improved outlook for future demand (linked to the incipient recovery in the euro zone) and the government's investment support plans suggest that the recovery in investment seen at the start of the year should have consolidated in 2Q13 (around +0.7% q/q).

On the foreign sector side, the most recent trade balance data suggests that net exports have continued to contribute positively to growth (around +0.2pp), with a resurgence of exports up to May (+3.2% on 1Q13), while imports grew at a slower pace (+1.4%) (see Chart 26). There are several factors behind this performance which we believe will remain in the following quarters, such as the recovery in the U.S. (16% of total exports) and, above all, the incipient recovery in the euro zone (45%), as well as the positive impact of the pound sterling depreciation in recent months (around 9% against the euro and 2% against the dollar since the end of 3Q12).

… with economic policy aimed at preventing the recovery from derailing

On the fiscal policy side, there have been no news over the last three months and the fiscal consolidation planned by the government until 2015-16 has continued, with a fiscal adjustment of around 0.7% of GDP in the 2013-14 fiscal year. The budget implementation data up to June is still insufficient for precisely assessing the development of public finances, especially when there are a number of exceptional measures (asset sale transfers to the Bank of England and the agreement with Switzerland) which make

their interpretation difficult. However, revenue growth and the reduction in expenses linked to improved activity are worth pointing out. With the data available so far, it seems likely that the government will reach the deficit target of 6.8% of GDP (+0.5pp compared to the previous fiscal year) forecast by the budget office (OBR), which will result in public debt increasing to around 95% (see Chart 27).

As for the other measures aimed at promoting growth, the most effective one seems to be financial aid for investment in housing, while the impact of the FLS would be more limited, mainly favouring deleveraging in the financial sector, but without this translating into greater credit availability, especially for non-financial corporates.

The most significant change could come from monetary policy, with a more active role in supporting economic growth, following the modification of the Bank of England's remit after the Budget presentation in March and the change of governor, more in line with this strategy, although the inflation target has not been relaxed and remains at 2%. After the meeting in July, both the report and the statements by some members of the monetary policy committee reflect this change, and have even been much more explicit on the development of the BoE's interest rate in the coming months. They are following a forward guidance strategy in order to curb the recent interest rate increase following the positive economic data released so far this year and the Fed's statements on its strategy for withdrawing unconventional measures. This would be more in line with the change adopted also by the ECB, although the BoE committee is still discussing this new strategy, and it will not be until August 7 (with the release of the Inflation Report) that an announcement will be made on whether it will adopt a strategy more similar to the Fed's, with monetary policy decisions linked to the performance of some intermediate target (i.e. an unemployment rate threshold of around 6.5-7% or allowing a deviation from the inflation target within the forecast horizon).

In any event, taking into account all the information available so far (and our scenario that recovery will consolidate with inflation above the target), it seems that the more orthodox members are gaining weight, partly due to the new role of this communication strategy. Therefore, our scenario suggests that the benchmark interest rate will remain at 0.5% until the start of 2015, while we believe that non-standard monetary policies will not be extended.

The strength of private spending will continue to support growth, above all in 2014...

Despite the fact that the private consumption fundamentals will not improve significantly within the forecast horizon, improved economic agents' confidence will result in a relatively low saving rate that will enable households to maintain the rate of spending registered in the first half of 2013. As a result, private consumption will increase over the year to +1.5%. In 2014, in addition to a slight improvement in the labour market, inflation moderation should also result in higher household purchasing power, so private consumption should once again increase (+1.6%), although still below pre-crisis growth rates (around +3%).

These expectations as regards the sustainability of private demand, together with the public investment plans and improved growth expectations in some of its main trade partners (euro zone and the U.S.) will be reflected in a recovery of investment, in a context where corporate profits have increased significantly since mid-2012 and the sector's credit conditions should continue to improve (despite the limited impact of the FLS). However, investment is one of the main changes in relation to our forecast three months ago. Firstly, due to a rebound in investment lower than the one projected for 1Q13 and, above all, due to the significant downward revision of the 2012 investment data, which now reflect an average quarterly decline of around -3% q/q from 2Q12 to 4Q12. Therefore, we now expect investment to contract in 2013 as a whole, with a lower contribution from domestic demand to GDP growth compared to three months ago.

Finally, the change in the fiscal consolidation pattern presented in March, as well as the budget implementation data up to June, confirm that public consumption will be neutral and, after growing slightly in 1Q13, we expect it to remain stagnant for the rest of the year. Despite this, the average annual growth will be +0.9% in 2013 (after reaching +2.8% in 2012) and will contract in 2014 (-0.7%).

As a result of aforementioned, we now expect the contribution from domestic demand to slow down in 2013 (+0.4pp after +0.8pp in 2012) and regain weight in 2014 (+1.6pp) due above all to the strong investment growth.

... but net exports will also contribute positively to growth

Unlike three months ago and reflecting, on the one hand, the downward revision of investment and, on the other hand, the strong decline in imports observed at the beginning of 2012, our forecasts now suggest a fall in it over 2013 (-1.4%). The factors supporting exports seem to be more favourable, with imports from the eurozone and the U.S. performing more strongly, and the depreciation of the pound sterling (just over 6% after appreciating around 6.5% in 2012). As a result, net exports will contribute

+0.6pp to GDP growth (-0.6pp in 2012). In 2014, greater dynamism of domestic demand will revive imports and the contribution from foreign demand will decline to +0.2pp. Given these developments, our scenario suggests that the current account deficit adjustment will continue, from 3.8% of GDP in 2012 to 3.1% in 2014.

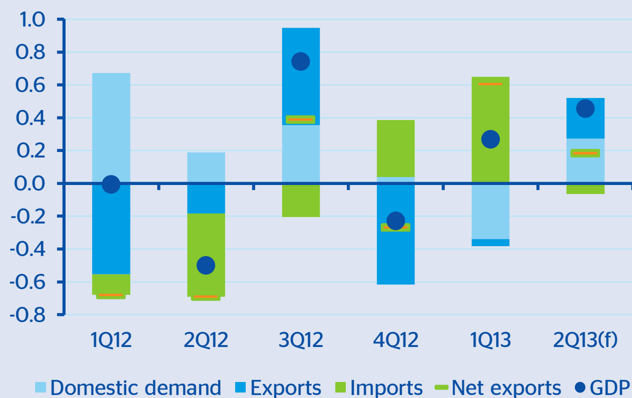
Growth somewhat below the potential, but constant within the forecast horizon

Bearing the foregoing in mind, our forecasts envisage a relatively robust and sustained GDP growth (similar to that seen in 2Q13) for the rest of the year, since the slight deterioration of domestic demand fundamentals seen at the beginning of the year (slight increase in unemployment and upturn in inflation, with a decline in disposable income) has been offset by improved economic agents' expectations and a greater contribution from net exports. We therefore maintain our growth forecast for both 2013 and 2014 at +1% and +1.9%, respectively (see Chart 28).

Inflation will remain above the target for the rest of the year, stabilizing slightly above 2% in 2014

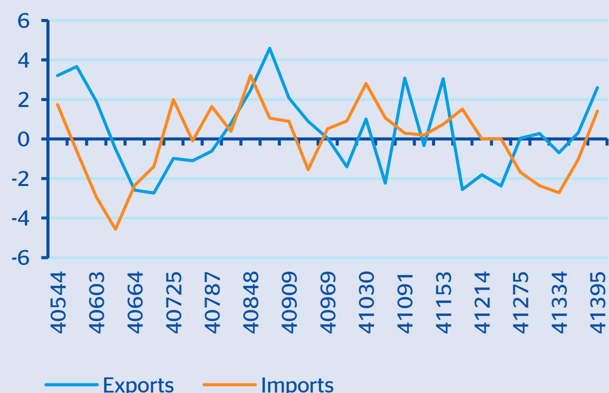
The upturn in inflation to 2.8% y/y in 1Q13 was basically the result of the strong increase in the price of energy products; partly linked to the depreciation of the pound sterling, while core inflation eased by 0.2pp to 2.5% y/y. This pattern has been repeated again in 2Q13, especially in June, with headline inflation increasing once more to 2.9% y/y and core inflation remaining stable at 2.5% y/y. However, we expect commodity prices and the pound's performance to stabilize in the coming months, and inflation to remain relatively stable in 3Q13 and ease towards the end of the year, more significantly at the beginning of 2014, hovering at around 2.2% y/y throughout 2014. We thus maintain our average annual inflation forecasts for both 2013 and 2014 at 2.7% and 2.2%, respectively.

Chart 25
Quarterly GDP growth (% q/q) and contributions (pp)



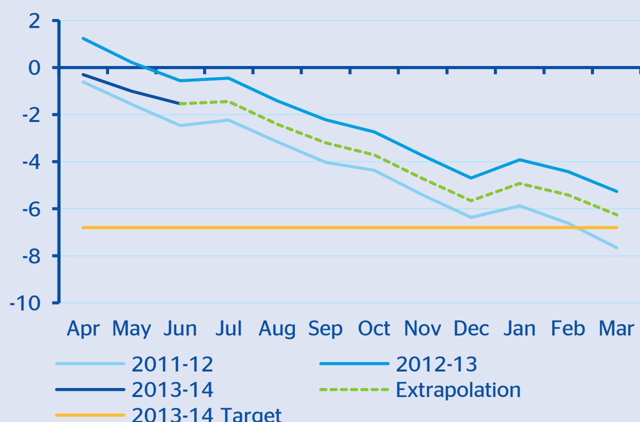
Source: ONS and BBVA Research

Chart 26
Trade balance. Exports and imports (% 3m/3m)



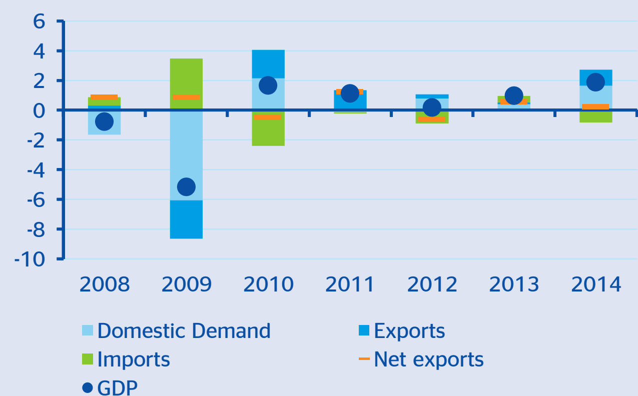
Source: ONS and BBVA Research

Chart 27
Public sector net borrowing excluding financial interventions (% of GDP)



Source: ONS and BBVA Research

Chart 28
Annual contribution to GDP growth (pp)



Source: ONS and BBVA Research

5. Tables

Table 1

Eurozone forecasts

(YoY)	2010	2011	2012	2013	2014
GDP at constant prices	**1.9**	**1.5**	**-0.5**	**-0.4**	**1.0**
Private consumption	1.0	0.2	-1.3	-0.4	0.6
Public consumption	0.8	-0.1	-0.4	-0.4	0.3
Gross Fixed Capital Formation	-0.5	1.5	-4.2	-3.6	2.3
Inventories (*)	0.6	0.2	-0.5	-0.1	0.0
Domestic Demand (*)	**1.3**	**0.6**	**-2.1**	**-1.1**	**0.8**
Exports (goods and services)	11.0	6.5	2.9	1.0	3.8
Imports (goods and services)	9.5	4.3	-0.7	-0.5	3.7
External Demand (*)	**0.7**	**1.0**	**1.6**	**0.7**	**0.3**
Prices and Costs					
CPI	1.6	2.7	2.5	1.5	1.4
CPI Core	1.0	1.7	1.8	1.4	1.3
Labour Market					
Employment	-0.5	0.4	-0.7	-0.7	0.1
Unemployment rate (% of labour force)	10.1	10.2	11.4	12.2	12.3
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-6.2	-4.2	-3.7	-2.8	-2.2
Public debt (% GDP)	85.4	87.3	90.6	94.5	94.8
External Sector					
Current Account Balance (% GDP)	0.0	0.1	1.3	2.0	2.1

(*) Contribution to GDP growth
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2010	2011	2012	2013	2014
United States	2.5	1.8	2.8	1.8	2.3
Eurozone	1.9	1.5	-0.5	-0.4	1.0
Germany	4.0	3.1	0.9	0.5	1.8
France	1.6	2.0	0.0	-0.1	1.1
Italy	1.7	0.5	-2.4	-1.8	0.8
Spain	-0.3	0.4	-1.4	-1.4	0.9
UK	1.7	1.1	0.2	1.0	1.9
Latin America *	6.1	4.4	2.8	2.6	3.2
Mexico	5.3	3.9	3.9	2.7	3.2
Brazil	7.5	2.7	0.9	2.3	2.9
EAGLES **	8.4	6.6	5.1	5.2	5.6
Turkey	9.2	8.5	2.3	3.7	4.8
Asia Pacific	8.2	5.8	5.3	5.3	5.6
Japan	4.7	-0.6	2.1	1.7	1.5
China	10.4	9.3	7.8	7.6	7.6
Asia (exc. China)	6.8	3.5	3.6	3.7	4.1
World	5.1	3.9	3.2	3.1	3.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 2, 2013
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(Tasas interanuales, %)	2010	2011	2012	2013	2014
United States	1.6	3.1	2.1	1.6	2.3
Eurozone	1.6	2.7	2.5	1.5	1.4
Germany	1.2	2.5	2.1	1.7	1.8
France	1.7	2.3	2.2	1.1	1.3
Italy	1.6	2.9	3.3	1.6	1.7
Spain	1.8	3.2	2.4	1.7	1.1
UK	3.3	4.5	2.8	2.7	2.2
Latin America *	6.4	8.0	7.5	8.7	8.7
Mexico	4.2	3.4	4.1	3.9	3.3
Brazil	5.0	6.6	5.4	6.3	5.9
EAGLES **	5.3	6.0	4.1	4.1	4.2
Turkey	8.6	6.2	8.5	7.2	6.0
Asia Pacific	3.6	4.7	3.0	2.8	3.3
Japan	-0.7	-0.3	0.0	-0.1	0.7
China	3.3	5.4	2.6	2.8	3.5
Asia (exc. China)	3.7	4.3	3.3	2.8	3.1
World	3.7	5.1	4.1	3.7	3.9

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 2, 2013
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Current Account (% GDP)

	2010	2011	2012	2013	2014
United States	-3.1	-3.1	-3.1	-2.8	-3.4
Eurozone	0.0	0.1	1.3	2.0	2.1
Germany	6.3	6.2	7.0	7.0	6.5
France	-1.6	-1.9	-2.2	-2.2	-1.9
Italy	-3.5	-3.1	-0.7	0.8	1.0
Spain	-4.5	-3.7	-1.1	1.0	1.7
UK	-3.3	-1.3	-3.8	-3.1	-2.8
Latin America *	-0.7	-0.9	-1.6	-2.1	-2.0
Mexico	-0.2	-0.9	-1.2	-1.3	-1.4
Brazil	-2.2	-2.1	-2.4	-3.3	-3.1
EAGLES **	1.6	0.5	0.4	0.3	0.7
Turkey	-6.4	-9.9	-5.9	-6.8	-6.8
Asia Pacific	3.3	1.6	1.2	1.3	1.8
Japan	3.6	2.3	1.7	1.2	1.5
China	4.0	1.9	2.3	2.8	3.5
Asia (exc. China)	2.0	1.4	0.4	0.3	0.7

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 2, 2013
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Government Deficit (% GDP)

	2010	2011	2012	2013	2014
United States	-8.9	-8.7	-7.0	-4.1	-3.5
Eurozone	-6.2	-4.2	-3.7	-2.8	-2.2
Germany	-4.1	-0.8	0.2	0.0	0.2
France	-7.1	-5.3	-4.8	-3.9	-3.3
Italy	-4.5	-3.8	-2.9	-3.1	-2.0
Spain *	-9.7	-9.0	-7.0	-6.5	-5.8
UK	-10.2	-7.8	-6.3	-6.5	-5.5
Latin America **	-2.5	-2.3	-2.6	-2.5	-2.6
Mexico	-3.4	-2.6	-3.1	-2.4	-2.3
Brazil	-2.5	-2.6	-3.0	-2.7	-3.6
EAGLES ****	-2.7	-1.8	-2.2	-2.2	-2.1
Turkey	-3.6	-1.4	-2.1	-2.3	-2.1
Asia Pacific	-3.6	-3.6	-3.6	-3.7	-3.1
Japan	-9.5	-10.0	-9.5	-10.0	-8.0
China	-2.5	-1.1	-2.1	-2.0	-1.8
Asia (exc. China)	-4.5	-5.3	-4.6	-4.8	-3.9

* Excluding aid to financial sector
** Fiscal year from 1 April to 31 March
*** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
**** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 2, 2013
Source: BBVA Research

Table 6

Financial Variables

Official Interest Rates (End period)	2010	2011	2012	2013	2014
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	0.75	0.50	0.50
China	5.81	6.56	5.75	6.00	6.00
10-year Interest Rates (Avg.)					
United States	3.2	2.8	1.8	2.3	3.0
EMU	2.8	2.6	1.6	1.6	2.2
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.76	0.72	0.78	0.77	0.77
EMU	1.33	1.39	1.29	1.30	1.30
UK	0.65	0.62	0.63	0.67	0.68
Japan	87.8	79.7	79.8	100.1	115.2
China (RMB per USD)	6.77	6.46	6.31	6.18	6.02

Forecast closing date: August 2, 2013
Source: BBVA Research

Table 7

Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	0.6	0.3	0.8	1.7	0.7	1.1	1.4
Public consumption	3.2	3.0	1.7	1.0	1.2	0.8	1.3
Gross Fixed Capital Formation	0.6	-11.5	5.6	6.4	-1.9	-1.1	4.1
Inventories (*)	-0.1	-0.8	0.6	0.2	-0.5	0.0	0.0
Domestic Demand (*)	**0.9**	**-2.2**	**2.4**	**2.4**	**-0.2**	**0.6**	**1.8**
Export	2.3	-12.8	13.4	7.9	4.5	-0.4	4.2
Import	3.0	-8.0	10.9	7.5	2.6	-0.1	4.8
Net export (*)	**-0.1**	**-2.9**	**1.6**	**0.6**	**1.1**	**-0.1**	**0.0**
GDP	**0.8**	**-5.1**	**4.0**	**3.1**	**0.9**	**0.5**	**1.8**
Inflation	**2.8**	**0.2**	**1.2**	**2.5**	**2.1**	**1.7**	**1.8**

(*) Contribution to growth
Source: BBVA Research

Table 8

France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	0.2	0.4	1.5	0.5	-0.3	-0.2	0.6
Public consumption	1.2	2.6	1.8	0.5	1.4	0.8	0.6
Gross Fixed Capital Formation	0.1	-10.4	1.2	3.0	-1.2	-2.0	2.2
Inventories (*)	0.3	-1.3	0.2	1.1	-0.8	0.0	0.0
Domestic Demand (*)	**0.1**	**-2.6**	**1.8**	**2.1**	**-0.9**	**-0.4**	**1.0**
Export	-0.6	-11.9	9.0	5.6	2.5	0.8	4.0
Import	0.6	-9.5	8.6	5.3	-0.9	0.0	3.4
Net export (*)	**-0.3**	**-0.5**	**-0.1**	**0.0**	**1.0**	**0.2**	**0.1**
GDP	**-0.2**	**-3.1**	**1.6**	**2.0**	**0.0**	**-0.1**	**1.1**
Inflation	**3.2**	**0.1**	**1.7**	**2.3**	**2.2**	**1.1**	**1.3**

(*) Contribution to growth
Source: BBVA Research

Table 9

Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	-0.8	-1.6	1.5	0.1	-4.3	-2.4	0.1
Public consumption	0.6	0.8	-0.4	-1.2	-2.9	-1.0	-0.3
Gross Fixed Capital Formation	-3.8	-11.7	0.5	-1.4	-8.0	-6.4	0.7
Inventories (*)	0.0	-1.1	1.1	-0.5	-0.6	0.0	0.0
Domestic Demand (*)	**-1.2**	**-4.3**	**2.1**	**-1.0**	**-5.2**	**-2.8**	**0.1**
Export	-2.8	-17.7	11.2	6.6	2.2	-0.2	3.6
Import	-2.9	-13.6	12.3	1.1	-7.8	-4.0	1.8
Net export (*)	**0.0**	**-1.2**	**-0.4**	**1.5**	**2.8**	**1.0**	**0.6**
GDP	**-1.2**	**-5.5**	**1.7**	**0.5**	**-2.4**	**-1.8**	**0.8**
Inflation	**3.5**	**0.8**	**1.6**	**2.9**	**3.3**	**1.6**	**1.7**

(*) Contribution to growth
Source: BBVA Research

Table 10
Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	1.3	-2.3	2.5	-3.8	-5.6	-3.3	-0.6
Public consumption	0.3	4.7	0.1	-4.3	-4.4	-4.0	-2.7
Gross Fixed Capital Formation	-0.3	-8.6	-3.1	-10.6	-14.5	-10.0	2.6
Inventories (*)	0.0	-1.1	0.9	-0.7	0.2	-0.4	-0.1
Domestic Demand (*)	**0.9**	**-3.6**	**2.0**	**-6.3**	**-7.0**	**-5.0**	**-0.6**
Export	-0.1	-10.9	10.2	7.1	3.2	3.9	4.8
Import	2.3	-10.0	8.0	-5.9	-6.7	-3.3	2.2
Net export (*)	**-1.0**	**0.6**	**-0.1**	**4.7**	**3.8**	**2.7**	**1.1**
GDP	**-0.1**	**-2.9**	**1.9**	**-1.6**	**-3.3**	**-2.3**	**0.5**
Inflation	**2.7**	**-0.9**	**1.4**	**3.6**	**2.8**	**0.6**	**0.8**

(*) Contribution to growth
Source: BBVA Research

Table 11
Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	**-0.6**	**-3.8**	**0.7**	**-1.0**	**-2.1**	**-2.6**	**-0.3**
Public consumption	5.9	3.7	1.5	-0.5	-3.7	-4.7	-1.8
Gross Fixed Capital Formation	-4.7	-18.0	-6.2	-5.3	-9.1	-6.5	1.1
Equipment and other products	-2.9	-23.9	2.6	2.3	-6.6	-2.7	5.1
Construction	-5.8	-16.6	-9.8	-9.0	-11.5	-9.4	-1.4
Housing	-9.1	-23.1	-10.1	-6.7	-8.0	-8.4	0.0
Other construction	-1.6	-9.1	-9.6	-11.0	-14.6	-10.2	-2.7
Inventories (*)	0.1	0.0	0.1	-0.1	0.1	0.0	0.0
Domestic Demand (*)	**-0.5**	**-6.6**	**-0.6**	**-1.9**	**-3.9**	**-3.8**	**-0.3**
Export	-1.0	-10.0	11.3	7.6	3.1	3.6	6.8
Import	-5.2	-17.2	9.2	-0.9	-5.0	-3.8	3.6
Net export (*)	**1.4**	**2.9**	**0.3**	**2.3**	**2.5**	**2.3**	**1.2**
GDP	**0.9**	**-3.7**	**-0.3**	**0.4**	**-1.4**	**-1.4**	**0.9**
Inflation	**4.1**	**-0.3**	**1.8**	**3.2**	**2.4**	**1.7**	**1.1**

(*) Contribution to growth
Source: BBVA Research

Table 12
UK: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	-1.0	-3.6	1.0	-0.4	1.1	1.5	1.6
Public consumption	2.2	0.6	0.5	0.0	2.8	0.9	-0.7
Gross Fixed Capital Formation	-6.9	-16.7	2.8	-2.4	0.5	-3.0	5.9
Inventories (*)	-0.2	-1.5	1.2	0.4	-0.6	-0.3	0.0
Domestic Demand (*)	**-1.6**	**-6.1**	**2.1**	**-0.1**	**0.8**	**0.4**	**1.6**
Export	1.1	-8.7	6.7	4.5	0.9	0.4	3.4
Import	-1.7	-10.7	7.9	0.3	2.8	-1.4	2.6
Net export (*)	**0.9**	**0.9**	**-0.5**	**1.2**	**-0.6**	**0.6**	**0.2**
GDP	**-0.8**	**-5.2**	**1.7**	**1.1**	**0.2**	**1.0**	**1.9**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.7**	**2.2**

(*) Contribution to growth
Source: BBVA Research

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