BBVA | RESEARCH

Economic Outlook

Europe

Fourth Quarter 2013
Economic Analysis

- **Global growth will accelerate in 2014** and continue to support European exports.
- **Drivers of the recovery are more positive in the eurozone,** while awaiting banking union…
- **… they will allow for moderate growth in 2014,** supported by domestic demand, which will be extended to all countries in the area.
- **The ECB will maintain its expansionary policy,** while fiscal policy will be less contractionary in 2014.

Index

1. Editorial 3

2. Global context: a slow global recovery with bearish risks 4

3. Eurozone: the recovery drivers are slightly more positive, pending the banking union 9

Box 1. Progress toward banking union continues 11

Box 2. Financial markets and monetary policy: the uncertainty associated with the action of central banks continues 13

Box 3. Fiscal Policy in 2014: A reduced fiscal consolidation, with less tax increases and more expenditure cuts 16

4. Outlook: slow recovery supported by domestic demand 19

Eurozone member states: detailed analysis 27

Box 4. Portugal: After hitting bottom in 2013, with a contraction lower than initially estimated, the economy should begin to grow in 2014 31

Box 5. United Kingdom: Economic policy should help to strengthen recovery within the forecast horizon 33

5. Tables 36

Closing date: November 4, 2013

1. Editorial

Some positive signs have emerged in recent months in the eurozone suggesting the region is already in the recovery phase. First, the growth data for the second quarter (0.3% q/q), led by Germany and France, was a positive surprise the emergence from the recession appeared to be taking place earlier and more strongly than expected. These figures, combined with more upbeat confidence during the summer and a better international environment led to a substantial improvement in financial markets over recent months (the second positive sign), with rises in stock markets, reduction in interest rates of long-term bonds and narrowing of sovereign debt spreads in peripheral countries (despite the political crises in Portugal and Italy), as well as an appreciation of the euro. The third good piece of news came from the peripheral countries, where the level of economic activity appears to have stabilized and growth could be returning, although with differences across countries.

All these news are positive. However, optimism should not give way to euphoria for a number of reasons. Growth in the second quarter was partly due to a rebound from temporary factors that had held the economy back at the start of the year. Moreover, the improvement in the confidence indicators slowed in September and October and has not been accompanied to the same extent by hard indicators. The improvement in market conditions is undeniable, but it does not appear to have much further to go, and the level of fragmentation of the financial markets in Europe is still very high. At the same time, the improvement in the periphery still has to be consolidated, and made compatible with the adjustments still pending, above all on the fiscal front (although now with more room to do so).

Thus the elements that support an exit from recession have barely changed, and neither have our forecasts. After declining 0.4% this year, the eurozone should grow by around 1.1% in 2014. Among the factors sustaining growth are the significant boost provided by the global economy; doubts have also dissipated in recent months with respect to the slowdown in some key emerging markets for European exports, such as China. Economic policy will also continue to play a role in the recovery, with a fiscal policy that already extended the deadline for deficit targets at the spring Ecofin meetings. This appears to have been seen as a change of stance by northern Europe, and as a result some countries seem to feel less concerned with meeting the targets. At the same time, monetary policy has been expansive and will continue to be so over the coming months.

The ECB, already concerned over the weakness of credit, the fragmentation of the financial system and the fragility of the recovery, is also facing an environment of low inflation and uncertainty regarding the financial system as the time approaches for the asset valuation and stress test exercises, which will take place next year. Our forecast is that the central bank may possibly once more provide liquidity through a LTRO, and although we do not expect cuts in official rates it is clear that this option will remain in place for some time.

A key factor in the performance of the Eurozone in 2014 and beyond, and also the major element of uncertainty, is the progress at European level on the banking union. The common supervision already underway, together with the approval and implementation of the single resolution mechanism by the end of 2014 with credible recapitalization funds that support the bank stress tests will be fundamental for restoring a single European financial system in the medium term, without which monetary union loses part of its meaning. Delays to this process, or lack of credibility with respect to its results, would be very negative for the zone and represent the biggest risk for forecasts in 2014. Other elements of uncertainty such as meeting the financing needs of Greece or Portugal by mid next year the fiscal fatigue in much of the zone or even the impact on the European rates curve of the reduction in asset purchases by the Fed are also important and will have to be monitored in the coming months.

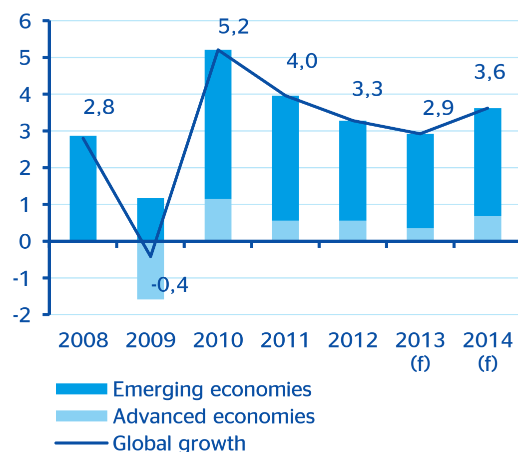
2. Global context: a slow global recovery with bearish risks

The economic cycle is improving, above all in advanced economies, although it is still far from a strong recovery

Two general features have characterized the last quarter for the global economic scenario. First, the confidence indicators of businesses and the volatility of the financial markets have continued to reflect the low probability of tail risk events, those that could be disruptive for the global situation. Thus economic recovery improves and there is less risk of it derailing. However, some events have contributed to a scenario of, at the end, a feeble global recovery within a one or two-year horizon. They are events with a current impact (the partial closure of the US government) but also a future one (the tightening of financial conditions due to expected end of the exceptional support of monetary policy).

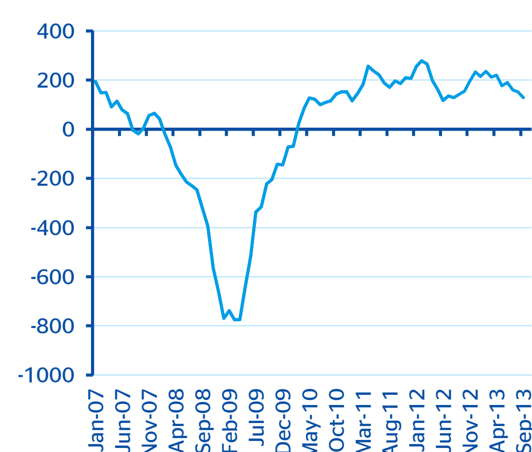
Overall, we have revised down by 0.2 pp the expected growth for the global economy in 2013 to 2.9% and in 2014 to 3.6%. The revision of 2013 growth is due to the worse figures recorded in the U.S. and the slowdown in some of the countries in developing Asia, which are also affected by financial turbulence in the wake of markets expectation of an imminent tapering of QE following FED's last May announcement. Growth in 2014 has also been revised down to 3.6%. The emerging markets are behind this downward revision, (except for China, where we stick to our forecasts), although they will continue to be the biggest contributors to global growth (Chart 1). The higher rate of global growth in 2014 is backed by an acceleration of the economy in all geographical areas, except for Asia, where growth is expected to remain at the same levels. Particularly worth noting is the improvement expected in the Eurozone after two years of recession, and the significant acceleration in Latin America after the blip in 2013 (see tables in the Appendix for more details).

Chart 1
Global growth (%)



Source: BBVA Research and IMF

Chart 2
U.S.: Private non-agricultural employment growth (monthly changes in thousands, 3-month moving average)



Source: BBVA Research and BLS

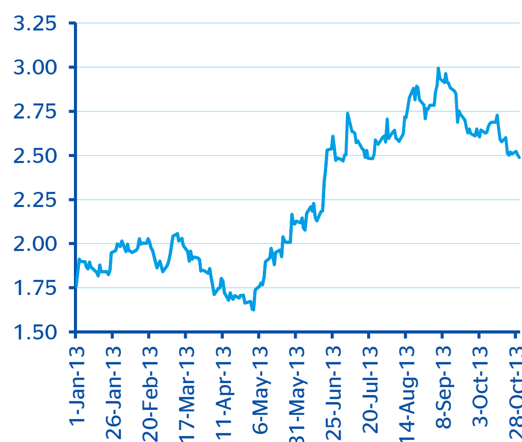
The tension in the financial markets caused by the announcement of the Fed's tapering eases, providing a boost not only in the U.S.

The Fed caused surprise when in September it decided not to start the process of tapering in its quantitative easing (QE) program. By delaying the start, it underpinned the nature of the program as data-dependent. It appears that the data have not been as expected since the time in May 2013 when the Fed began to outline it exit plans. The growth acceleration is still expected in the second half of the year, but Household's consumption is weaker than expected, while the real-estate market, which had been gaining strength, has suffered from the initial reaction to tapering. At the same time, the labor market continues to be weak (Chart 2), and there is uncertainty inherent to the prolonged negotiations on the budget and the public debt ceiling, which have to be repeated in a few weeks. The lack of long-term solutions and the repetition of a brinkmanship strategy in fiscal negotiation increase the probability of a slowdown in decisions on expenditure and investment, as well as the direct impact of the partial closure of government activity.

The clarifications on the process of tapering, which the Fed's members are preparing in the light of the unexpected reaction of the market to their first announcement and its delay until (possibly) the start of 2014, have reduced the risks of a derailment in the recovery. The initial market response to the tapering announcement tightened financial conditions in advanced economies to over-restrictive level for their cyclical moment, as well as putting a sudden brake on finance in some emerging markets, particularly those with the weakest fundamentals and that are at the same time financially most integrated.

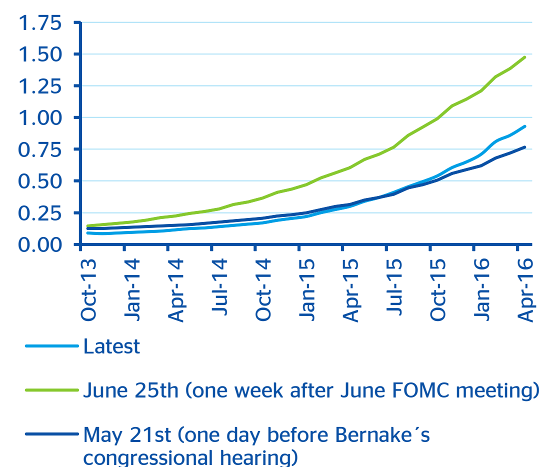
However, much of the rise in long-term interest rates recorded since May has been reversed (Chart 3). The markets do not now anticipate rises in Fed Funds rates until 2015, in line with what was discounted by the market immediately before Bernanke suggested that he would initiate the tapering process (Chart 4).

Chart 3
U.S.: yield on 10-year government debt



Source: BBVA Research

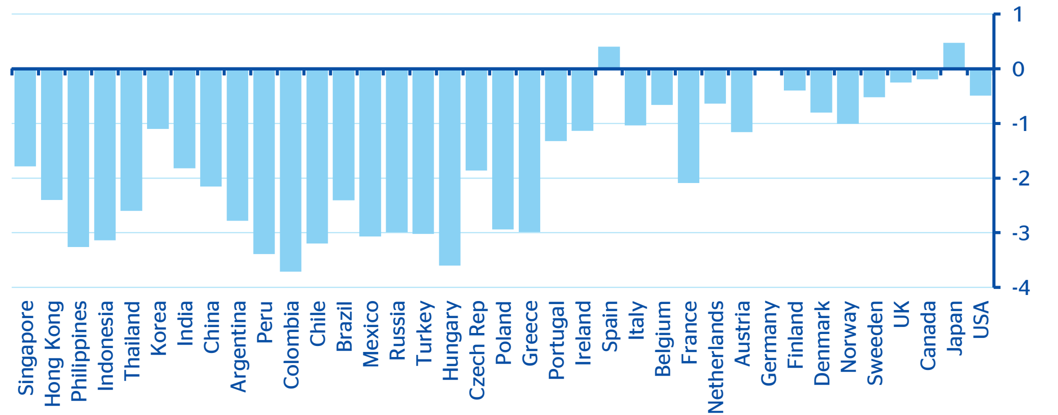
Chart 4
U.S.: implied Fed fund rates



Source: BBVA Research

In addition, volatility and financial tensions have eased at a global level, particularly regarding emerging markets in Asia and Latin America, which are also affected by major capital flight. The first signs that the Fed could be considering putting an end to its monetary expansion program (with all the reservations and steadiness adopted) led to a major depreciation of the currencies of emerging markets, as well as major capital flight (Chart 5). These financial tensions coincided with doubts about the performance of these economies during a slowdown that was becoming more marked.

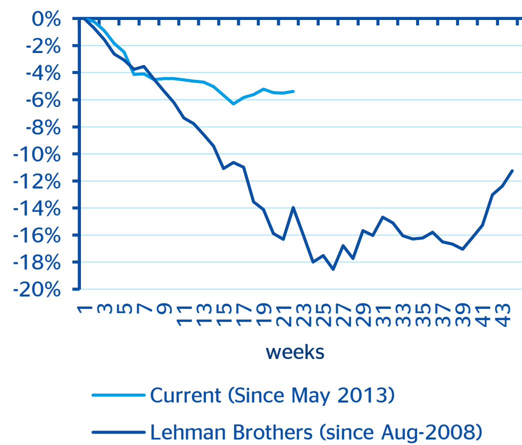
Chart 5
Flows to emerging economies (over total portfolio assets, June 2013, %)



Source: BBVA Research and EPFR

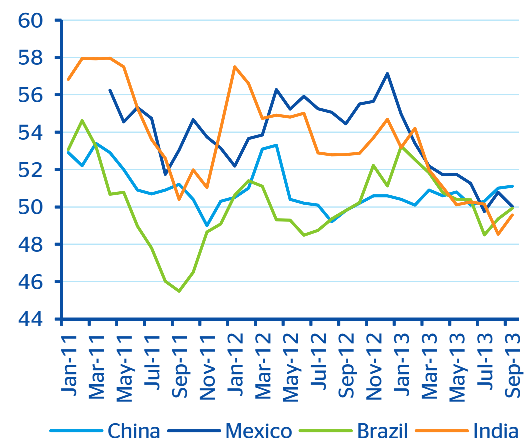
The severity of capital flight and the depreciation of currencies following expectations of an imminent tapering raised fears of a "sudden stop" of emerging markets funding and then a steep fall in economic activity. However, the sell-off process has gradually been losing intensity, and as can be seen in Chart 6, we are far from the level of severity of capital outflows observed after the collapse of Lehman Brothers. At the same time, emerging markets show some indications of a recovery in confidence, after the check in the middle of the year (Chart 7).

Chart 6
Portfolio flows to emerging markets (% assets under management, compared with pre-crisis levels)



Source: BBVA Research and EPFR

Chart 7
Emerging markets: manufacturing PMI



Source: BBVA Research and Haver

In any event, tapering will end up arriving, and change the global scenario of liquidity injections that favored indiscriminate flows to emerging markets. The impact of tapering, once it is effectively underway, will probably be a greater discrimination in flows toward emerging markets according to the fundamentals of each of them (current-account deficit, foreign-currency debt levels, greater or lesser maturity of short-term debt, etc.). In any event, the extra time allows a reduction in the risk of a sudden fall in economic activity, at least in the short term.

The fiscal agreement in the U.S. has been another patch that does not address long-term fiscal sustainability and does not avoid a contractive short-term impact

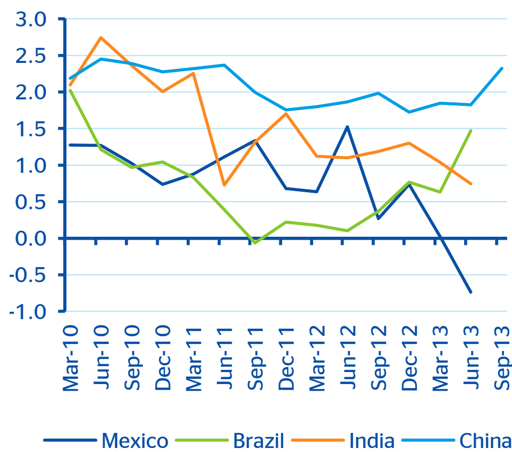
On October 16 agreement was reached between the two parties in Congress and the Senate allowing the reopening of the Federal Government after two and a half weeks of closure, and elevating the debt ceiling. However, the agreement reached is a simple extension of the current situation, as it only includes that the Government will have finance until January 15, while the new debt ceiling will be reached on February 7 (though it could be extended until March, with "ingenious" measures by the Treasury). In addition, the agreement creates a committee of 29 members of Congress and the Senate who will have to propose a plan before December 13 on a 10-year budget horizon.

Intense negotiations are drawing near on cuts in discretionary expenditure and increases in taxation. The U.S. thus once more has to address an uncertain process that it has already passed through in these months on previous occasions, and this can only have negative consequences. First, there is the perception that the political confrontation has been too bitter, and that it could have an impact on the electoral outlook. This suggests that a more moderate stance that is more prone to making pacts when the February deadline approaches. Second, the closure of the Government will also have economic consequences, and not only direct ones. It is true that the markets have so far remained relatively immune to the imminent possibility of an event as disruptive as a default on the risk-free asset of the world economy. It seems self-convinced that, in one way or another, an event of this magnitude would be avoided, through a last-minute pact, as in fact happened. That is not to say that there has been no impact on the economy. Most likely is that the partial closure of government for 16 days has had a relatively marginal direct effect on the GDP for the quarter, perhaps a few tenths of a pp. However, the threat of this process continuing may have an additional impact. This effect, more difficult to measure, would be through the drain on consumption and investment in the face of increased political uncertainty related to the government's capacity to meet its spending commitments. Overall, we consider that the decision that the Fed has to take on when to start the reduction in its asset purchase program (between December and the first quarter of 2014) will only depend on the state of the economy. In any event, the situation in which economic policies push in opposing directions will continue, with a loose monetary policy that will continue to be so for a long period, and an unnecessarily contractive fiscal policy in the short term. Thus the U.S. public deficit will have fallen without market pressure (unlike in Europe) from 6.8% in 2012 to 4% in 2013, which can be considered a drain of 1.3 percentage points of GDP growth in 2013. And the long-term challenges for the fiscal sustainability of the U.S. economy have not been tackled.

China once more stimulates its growth, but in a more limited fashion; its increased demand drives other economies

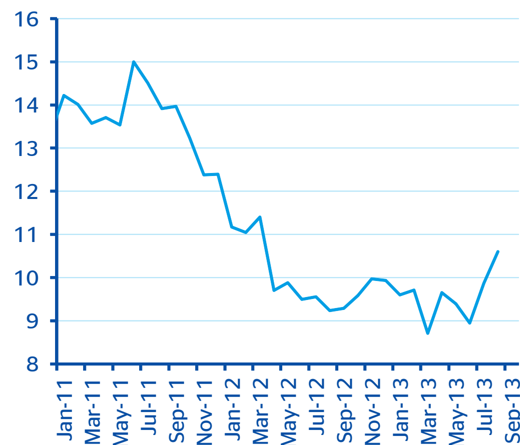
In China, the doubts at the start of the year on the possibility of a sharp adjustment in its economy have also dissipated, at least in the short term. Over the year, the economy has maintained a high rate of growth, and the most recent data (third quarter) suggest that the GDP is picking up (Charts 8 and 9). The better than expected figures in 2013 mean that the annual growth outlook has been revised upward slightly from 7.6% to 7.7%. Even so, doubts remain on the sustainability of growth in the medium and long term, as the recent upturn in growth has been the result of the improvement in foreign demand, but also of one-off measures of tax policy and public spending with a renewed use of credit. This means that financial vulnerabilities have been allowed to increase; they are still manageable, but they have to be addressed. Priorities include reducing excessive reliance of credit in some sectors of the economy; advancing domestic financial liberalization and reducing the role of shadow banking; and reforming fiscal relations to address high local government debt. The appropriate management of these aspects must ensure a steady transition, a re-balancing of growth toward more weight of domestic demand and household consumption.

Chart 8
GDP growth in emerging markets
(q/q %, seasonally adjusted)



Source: BBVA Research and Haver

Chart 9
China: index of industrial output (y/y %)



Source: BBVA Research and Haver

Risks in the forecast: downward biased but with less probability and lower impact

The risks to the moderate recovery scenario with a growing contribution from advanced economies and a sustained contribution from emerging markets have been reduced. This does not take away the fact that the balance of risks continues to be downward. It is worth pointing out first due to its character the possibility of a "disorderly exit" from the Fed's QE, which could generate an excessive increase in interest rates (in the U.S. and in other countries), not as a result of improved growth prospects or higher inflation, but due to uncertainty regarding the rate of exit planned by the Fed. Financial conditions that are too tight for the rest of the world could terminate a global recovery if it is not especially dynamic, as it is particularly in the Eurozone. In addition, it is also worth noting as a risk the resolution of the fiscal questions in the U.S., the budget and the debt ceiling, which have now been postponed until the first quarter of 2014. The negotiations that the parties have to carry out until then are a potential source of uncertainty and may lead to an additional drag if the fiscal drain increases.

Second, it is worth identifying as a risk factor the adjustment in growth in China and in other emerging markets. This could be the result of idiosyncratic factors, but also of dilemmas to which domestic policies have to address in a more acute global financial environment. Although as has been seen recently, the differences between economies are relevant, and an interruption in the recovery underway is not to be expected unless there are financial scenarios that are as adverse as those registered between the end of 2008 and 2009.

3. Eurozone: the recovery drivers are slightly more positive, pending the banking union

The last few months in the eurozone have been in line with the outlook of slow recovery, despite the good news that has surprised many analysts and the markets and boosted the stock markets and financial variables during the summer. On the one hand, there has been the positive surprise of growth in the second quarter. In our case, we had in fact expected the exit from recession at the start of the year (this did not happen, partly due to temporary factors). But on the other hand, the most recent data have confirmed some moderation in the latter part of the year.

Our scenario still assumes that the main factors behind the eurozone crisis will continue to ease, although they are far from disappearing entirely. In particular, after recent progress, we assume that the European authorities will continue to make progress toward banking union (Box 1), which will help credit flows progressively to the private sector in the periphery and lower the funding cost. 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 (with many structural reforms already underway). This means there will be no deterioration in their situation with respect to the markets. Having said that, the process of fiscal consolidation is subject to less pressure from Brussels and the countries of northern Europe, which gives some room for recovery in the short term. In addition, monetary policy will continue to be expansive, given the ECB's concern for consolidating the recovery, due to the indirect effects on Europe of the tapering in the United States, and no less importantly, due to the uncertainties linked to the eurozone banks' asset quality review that will take place in 2014.

All these factors will shape the speed of recovery in Europe and determine its risks. They will be analysed below.

The external environment is still positive, despite doubts about the emerging markets in the first half of the year

Despite some slight divergences from our projections for the different economic regions (positive surprises in the developed economies and negative ones in emerging markets), we still project a robust global growth that will be key for consolidating recovery in Europe, particularly in the periphery. Our BBVA-GAIN model estimates an acceleration of global growth in 2H13(0.7% q/q in 3Q13 and 0.8% q/q in 4Q13, following on from 0.4% q/q in 2Q13, Chart 10). However, the slightly lower than expected global GDP growth in 1H13 (emerging Asia, excluding China) means that we have revised our forecast for annual global growth for both 2013 and 2014 slightly down by -0.2pp, to 2.9% and 3.6% respectively, with a negligible impact on our projections for exports in the eurozone as a whole.

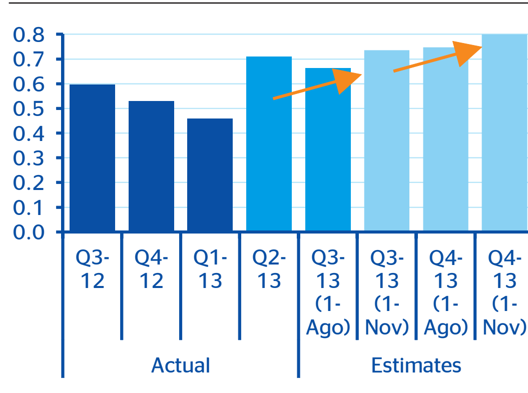
In addition, our forecasts suggest that the recent appreciation of the euro will ease in the coming quarters. We expect the currency to depreciate by average of 1% in 2014, so it will not be a drag on the competitiveness of eurozone exports.

The financial conditions of the Eurozone have not worsened, despite the political crisis in some peripheral countries

Secondly, despite various accidents in the periphery (political crises in Portugal and Italy), some delay in banking union and a certain paralysis in decision-making at European level caused by the German elections, financial tensions have remained tied (Chart 11), with fewer funding problems in the periphery and more evidence that some of the measures adopted last year are

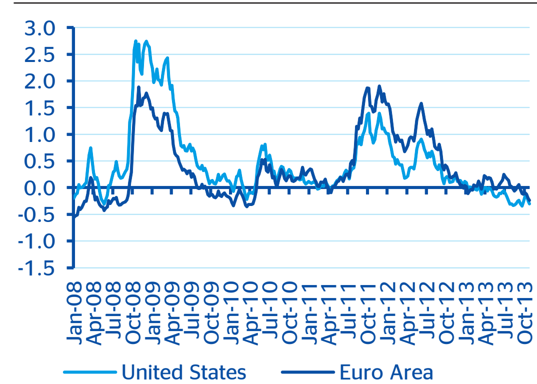
still effective. This has also led to a lower risk perception in those countries. However, despite financial fragmentation reducing to a moderate extent recently, the problem will continue in the short term with the interest-rate spreads of the peripheral countries remaining high.

Chart 10
Growth of global GDP according to the BBVA-GAIN (% q/q)



Source: BBVA Research

Chart 11
BBVA Research Financial Stress Indicator



Source: BBVA Research

In this context, monetary policy will continue to be accommodative, while fiscal policy will be less restrictive

The ECB is still cautious about assessing the recent activity data and, in line with our scenario, envisages a slow and moderate recovery throughout the forecast horizon, with inflation forecasts clearly anchored below 2%. The main concern of the monetary authority continues to be the fragmentation of the financial markets and the disruption of traditional channels of monetary policy transmission. In the context of the ECB's new forward guidance strategy, it must ensure that an accommodative monetary policy will be maintained in the forecast horizon, without ruling out another interest-rate cut or a new liquidity provision in the coming months. The recent reduction in year-on-year inflation to below expectations in fact introduces a downward bias to monetary-policy expectations (Box 2).

As for fiscal policy, the latest data on budget execution through September suggest that most countries are on the way to meeting the new fiscal targets redefined in spring (or with a very slight slippage), and have moderated the pace of fiscal consolidation set previously. This will continue next year, as reflected in the various national budgets presented recently, with a fiscal effort clearly less ambitious than that envisaged in the stability programs. In short, this slower pace in the adjustment of fiscal imbalances, more focused on the structural component to avoid compensating the cyclical deterioration, should weigh less on economy recovery (Box 3).

The risks in the eurozone remain tilted to the downside, although they are lower than a few months ago

A resurgence of the euro crisis is still a risk not only for Europe, but also at global level. The authorities have to support the good perception of the markets with decisive progress to strengthen monetary union, in particular banking union. Overall, there are numerous elements that could make the improved perception reverse, and that could endanger the recovery that is outlined in the following section. Some peripheral countries are in a situation of "reform fatigue", lack of political consensus that could put a brake on the necessary reforms. Negotiations on the programs of Portugal and Greece may be a source of uncertainty. In addition, shortly work will begin on the review of the bank balance sheets and the stress test to risk scenarios, needed for the implementation of a single banking supervisor, could give rise to negative surprises. Finally, as has been shown by past experience, disagreements on the definition of policies that strengthen the euro area, in this case bank resolution mechanisms may produce tensions and volatility in the financial markets.

Box 1. Progress toward banking union continues

The last European Council meeting of October 24-25 concluded with a restatement of the timetable and firm commitment by the authorities to the project. The most important points were the call for: (i) coordination and establishment of national backstops for the integrated review exercise to be carried out by the ECB on the balance sheets; (ii) adoption of the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Directive by the end of the year; (iii) finalization of the rules for direct recapitalization through the European Stability Mechanism (ESM); and (iv) agreement within the Council before the end of the year on the proposal by the European Commission to create a Single Resolution Mechanism (SRM) with the aim of achieving final approval before the end of April 2014. This date will mark the end of the European Parliament's current legislative period.

One of the main objectives of the Eurozone in its strategy for emerging from the crisis is to break the vicious circle between banking risk and sovereign risk and put a stop to financial fragmentation in the Eurozone. In order to do so, there is no alternative but to make progress with banking union. It is important to highlight what has been achieved so far. The agreement to create a single supervisor is a major milestone in the project of European construction.

The deployment of the Single Supervision Mechanism (SSM)

After the approval of the SSM by the European Parliament on September 12, 2013 and the ECOFIN on October 15, 2013, the regulation establishing that the ECB will be the single supervisor for the Eurozone entered into force on November 3, 2013. In accordance with its provisions, single supervision must be fully operational one year later.

But before the ECB can assume the direct supervision of the 130 most important banks in the Eurozone, a satisfactory and final solution must be provided for the question of legacy assets, meaning inherited assets of doubtful value. This will be done through a three-part exercise combining: (i) risk valuation; (ii) asset quality review (ASR); and (iii) valuation of the balance sheets, with results to be published in October 2014. The exercise will mark a dividing line between the problems of the past, which must be managed at a domestic level, and those of the future, for which a European-level management may be expected. It should help strengthen confidence in banks and restore the normal credit operations. That is why it is important for the exercise to be robust and credible. A number of elements must be present to ensure this is so: a solid methodology; cooperation by the national authorities; transparency to ensure the market can replicate the exercise; and the establishment of national public support (duly backed in the last instance by the ESM through the sovereign debt if necessary, as in the Spanish model). The European Council has urged the re-establishment of a coordinated European approach by December 2013 based mainly on national public support to comply with the Commission's regulations governing state aid.

Among the supervisor's next challenges are its appointments policy and the more operational questions.

Hiring the team is undoubtedly an important part of establishing the authority. The ECB has already begun the process of setting up the Supervisory Board, which will be answerable to the Governing Council of the ECB. The necessary safeguards have been implemented to guarantee independence in decision-making, both in terms of supervision and monetary policy. The organizational structure will consist of four Directorates General (DGs): DG I and II will conduct direct supervision over the 130 most significant banks, with DG I being responsible for banks with the highest risk exposure; DG III will be in charge of indirect supervision over the less significant banks in the Eurozone, with direct supervision over them being conducted by the national supervisors reporting directly to the ECB; while DG IV will provide horizontal support to the rest of the units and specialist functions such as development of methodologies, validation of models and enforcement of sanctions. It is estimated that in total the workforce will number around 1,000.

To assist the operational deployment of the new supervisor, the transmission of knowledge from the national supervisors to the ECB must be ensured through the creation of joint supervisory teams. In the Spanish case, this transmission from the Bank of Spain to the ECB is particularly important due to the special nature of the resolution model for Spanish banks (multiple entry-point strategy) within the European context. At the same time, a manual with best practices will have to be prepared, to be used as a reference for future single supervision.

The Single Resolution Mechanism (SRM): aiming for agreement by the end of 2013 and approval by April 2014

The Single Resolution Mechanism is a key pillar of banking union. On July 10, 2013, the European Commission presented its proposal for a Regulation to establish the SRM in 2015 with the aim of ensuring uniform implementation of the resolution rules in the Eurozone. The proposal included the creation of a single resolution authority, which due to the legal limitations of the Treaties will be in the hands of the European Commission and will be supported by a new Single Resolution Board on which the national resolution authorities will be represented. It also includes the establishment of a single resolution fund financed by the industry to act as mutualized private-sector support in case the capacity of the creditors of the bank in question to absorb losses is not sufficient to resolve the bank. The regulation must be approved by the Council (in principle before the end of the year) and by Parliament before the end of its legislative term in 2014.

Agreement on this point is of particular importance for ensuring a correct transition between single supervision and single resolution. It is difficult to imagine a situation in which the ECB as single supervisor could adopt a decision on a bank with resolution implications that must be executed by a national authority with its own resolution fund. A single supra-national supervisor requires a transnational resolution authority to avoid inconsistencies in the procedure.

The discussion on this proposal perhaps results more complex than the SSM negotiation, as in this case, as well as ceding sovereignty over bank resolution; it includes a mutualization of funds, which could be interpreted as a step toward fiscal union. That is why the proposal is still being openly debated in the Council.

The positions revolve around two approaches: (i) those (including the Commission) in favour of a centralized resolution scheme; and (ii) the group headed by Germany, which aims to reduce the framework to one of simple coordination of the network of authorities and national funds, without creating a single authority or a single fund until a reform of the treaty can make progress toward a powerful SRM.

The main concerns of the European Parliament and Council have been tackled in the new texts proposed. They aim to (i) reduce the power of the Commission to trigger the resolution, with its function limited to that of supervisor; (ii) make it possible for the single resolution fund to have access to a line of public finance; and (iii) ensure greater protection for national budgets.

The wide-ranging discussion on the legal basis of the proposal has also been reflected in two reports by the Council's legal services, both favourable to the Commission's proposal but with some reservations. While the first asked for an introduction of mechanisms to protect the national budgets, the second report requested a limitation on certain functions of the Single Resolution Board so that it could be compatible with the Meroni doctrine[1].

Regardless of how the discussions develop, the Regulation finally governing the SRM must help break the vicious circle between sovereign debt and bank funding and reverse the fragmentation of the financial markets in the Eurozone. To achieve this objective, it is important to continue to take steps toward the completion of banking union. Once the single supervisor is finally approved, the market will focus attention on the design of the strategy of a credible SRM that can act as a counterparty of the single supervisor to avoid inconsistencies. Ideally, a single authority and a single resolution fund are required. However, given the current reticence, it is important that the mechanism resulting from these negotiations should at least have a coordinated/centralized system of decision-making and an ex-ante determination of burden-sharing rules for using funds.

1: The Meroni doctrine establishes that powers held under the Treaties may only be exercised by an authority that is included in the Treaties. In other words, in this case an autonomous resolution agency cannot be created, only an agency that answers to an existing authority.

Box 2. Financial markets and monetary policy: the uncertainty associated with the action of central banks continues

In recent months both the European and U.S. debt markets have adjusted their yields down to a significant extent. Interest rates have corrected around 40% of the rise recorded since June, when Ben Bernanke announced the possibility of starting to moderate the rate of asset purchases some time this year. This has given rise to some relaxation of the financial conditions that had been tightening swiftly since the spring.

The element that has guided the correction of expectations and that has also kept financial markets volatile has once more been the Federal Reserve. Its effect has been noted in other financial markets, above all in emerging markets, but also in Europe. At its meeting in September the Federal Reserve surprised the market and the consensus of analysts by maintaining the pace of asset purchases (in other words, not starting the tapering process) and showing a relatively downward stance. This decision was influenced by the data for U.S. economic activity, which have not completely dissipated doubts regarding the sustainability of the recovery, fiscal uncertainty or tougher financial conditions after the major upturn in interest rates in previous months. This confirms that the start of the withdrawal of stimuli does not have a fixed timetable, but is completely dependent on economic developments. The Fed's decision had a major impact on market expectations regarding rises in interest rates and the withdrawal of stimuli in the United States, which in turn led to a reversal in debt markets that has lasted until now. Specifically, 10-year U.S. debt interest rates have fallen by around 50 basis points since the highs of early September.

The yield curve in Europe, closely related with the American, has moved in parallel. In the long sections of the yield curve, interest rates have declined around 30 bps from their highs. The short sections have declined relatively in line with the long sections, and the impact is slightly higher on the middle sections. The ECB had been uneasy with the tension of previous months (caused by the carryover effect from the Fed's statement), as interest rates did not correspond to the cyclical situation of the Eurozone, which is lagging behind and more fragile than the cyclical situation of the U.S. economy. However, this tension has also moderated significantly.

Overall, following this movement, long-term debt interest rates are even below the levels of three months earlier, both in the United States and Germany. Equally, monetary policy expectations have been substantially corrected. These levels of rates are considered more in line with expectations of a gradual recovery of both the American and European economies, as well as a very steady exit from the ultra-expansive policies applied by the central banks.

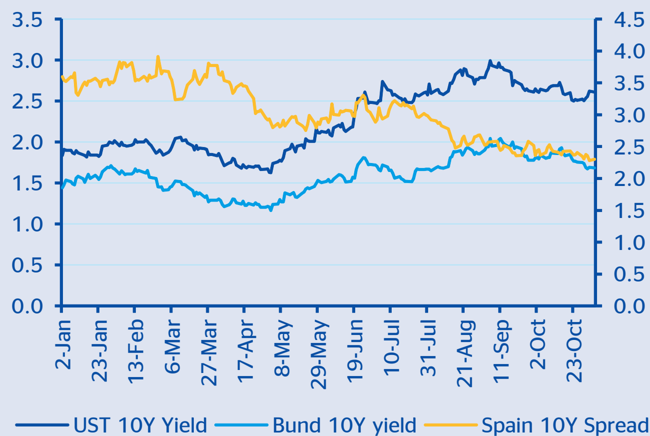
The ECB communication would also have contributed, although marginally, to the correction of the European curve. In reality, the ECB has not adopted any change either in its monetary policy or its policy of liquidity provision in recent months. However, it has maintained and even heightened the downward tone already announced in July, when it included the concept of "forward guidance" in its communication to sustain its vision of future monetary policy. In recent meetings and statements the ECB has emphasized that there is additional margin for relaxing the monetary conditions in the Eurozone, whether through interest rate cuts or non-standard policies such as the extension of the current long-term refinancing operations (LTROs). Under our baseline scenario, in which the economy continues to recover at a slow pace and inflation remains under the ECB target, but around 1% in 2014, the ECB will maintain interest rates stable at 0.5%, although the downward bias continues, mainly due to the impact that the appreciation of the euro could have both on growth and, above all, on inflation. In recent months, the combination of the delay in the withdrawal of stimuli by the Federal Reserve, uncertainty regarding the resolution of the fiscal debate in the United States and the positive surprises to growth in the Eurozone have contributed to an appreciation of the euro (a nominal 3.7% against the dollar, but also in real effective terms). Specifically, a permanent appreciation of the euro of 4% could drain around -0.1 pp of GDP this year and -0.3 pp next year, while it could reduce inflation by around 0.1 points in 2013 and just over 0.2 points next year. It would therefore delay recovery still more, while it could push inflation rates somewhat below 1%. Thus, if the exchange rate continues to appreciate, it could become a determinant factor for action by the ECB.

On the liquidity side, in recent months the banks in the Eurozone have sped up their rate of early repayment of the LTROs, particularly in the case of Spanish, Italian and French banks. This could be interpreted as a positive sign. At the close of the third quarter, 35% of the total money taken in the two LTROs has been repaid, with different proportions between core and peripheral countries. Core countries have repaid around 60% and peripherals 20%, with significant differences between them: the Spanish banks have repaid around 30%, while Italian banks around 11%. Equally, another positive piece of data in the last month has been that issuance by banks has restarted, including medium-sized peripheral banks.

Yet, although liquidity is not a problem, the markets are far from recovering normal conditions, as shown by the indicator of fragmentation in the Eurozone. According to this indicator, although the Target 2 positions have been considerably reduced, as well as the dependence on ECB liquidity, the degree of dispersal of interest rates applied by the different financial systems to households and companies continues at very high levels. In this context, and after the approval of the single banking supervisor (a function that the ECB will assume within a year), it has already been announced that the banks in the Eurozone will in 2014 undertake a comprehensive exercise to assess their balance sheets (including an Asset Quality Review), as well as stress tests that could in some cases result in additional capital requirements. As Mr. Draghi himself has stated, the ECB will take all the measures necessary to avoid any accident that may prevent the recovery from taking hold. In our opinion, the uncertainty that could result from this exercise in a fragile macroeconomic environment with inflation well under target may push the ECB to adopt some type of measure in the coming months, with the most plausible liquidity scenario being an extension of the current LTROs. However, the key issue to credit recovery and consolidation of activity in Europe, rather than previous measures, is to restore transmission mechanisms of monetary policy, reducing as much as possible the financial fragmentation.

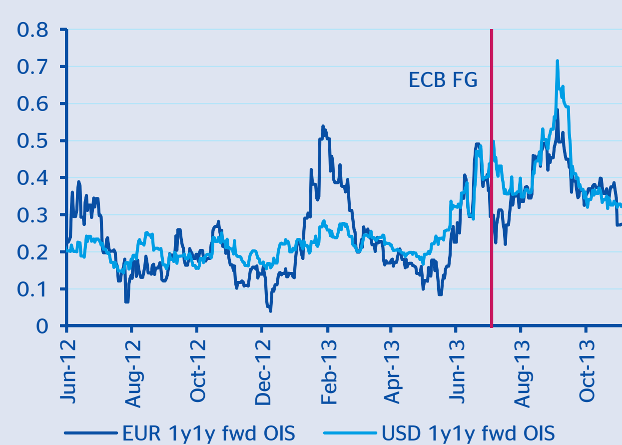
In this context, the European peripheral debt has behaved very favourably. The debt interest rates in both Spain and Italy have continued to fall, with reductions that are even greater than those of the German debt, so the debt spreads have also narrowed. This is despite, for example, the political noise in Italy and the challenges pending in the process of constructing a banking union. The recent trend in risk premia is compatible with our view of a steady reduction, in line with the correction of imbalances and gradual cyclical recovery, although the levels achieved may be the result of less structural factors. In recent months capital flows have been more favourable to Europe than other geographical areas[2], and this could have benefited the peripheral countries in particular, providing an additional downward boost to the risk premium.

Chart 12
Bund & UST 10Y yields and Spain spread



Source: Bloomberg

Chart 13
1y1y forward OIS in the EUR and USD markets (%)



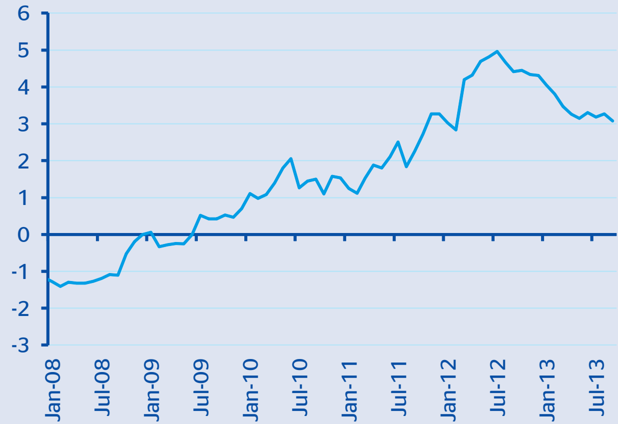
Source: Bloomberg

2: High-frequency fund flow data and surveys of international fund managers reveal that in the last quarter Europe has been one of the most attractive destinations

Chart 14
Liquidity surplus (EUR bn)

Source: Bloomberg and BBVA Research

Chart 15
Indicator of Eurozone fragmentation



Components: (i) coefficient of variation of credit interest rates (mean) between countries (ii) Balance TARGET2 (iii) provision of Eurosystem liquidity as a percentage of bank assets, (iv) interquartile range of interest rate of two-year bonds. To combine these indicators we normalize them and then we estimate principal components.
Source: ECB, Bloomberg and BBVA Reserch

Box 3. Fiscal Policy in 2014: A reduced fiscal consolidation, with less tax increases and more expenditure cuts

With only a few months to go before the end of the year, the latest forecasts for the fiscal deficit have confirmed the trend begun in May, when the European Commission allowed a relaxation of fiscal consolidation (Chart 16). This decision was taken to minimize the negative impact of restrictive policies on the economy, and mainly because a major fiscal effort had already been made since the start of the crisis. In the 2010-2012 period, the countries in the Eurozone made fiscal adjustments amounting to an annual mean of 1.4 points of GDP, but this effort will fall to an annual mean of 1 point of GDP in the period 2013-2014 (Chart 16). As a result, the structural deficit will fall to 1.6% in 2014 from 5.5% in 2010, thus ensuring that the recovery is not held back by over-restrictive fiscal policies, but maintaining the fiscal consolidation path.

Following the timetable set for the "two-pack" (the new legislative package for budget supervision in the Eurozone) in mid-October the countries presented their draft budgets for 2014. In general, the budgets were in line with two basic trends: i) confirmation of the relaxation of fiscal consolidation already observed in the stability programs presented in May; and ii) a change in the fiscal policy approach in 2014, which is more focused on expenditure cuts than the measures to increase revenue that had dominated in recent years (around 60% of the total effort). Below we analyze the fiscal situation of several countries of the eurozone.

France

The draft budget for 2014 estimates that 2013 will close with a deficit of 4.1% compared with the figure of 3.9% initially forecast in the document presented in May to the European Commission, this new forecast is in line with ours, once incorporated the last data about budget execution.

With respect to 2014, the fiscal effort (€18bn, equivalent to 0.9% of GDP) will for the first time be focused on the reduction of expenditure (€15bn, 80% of the total fiscal effort) rather than greater fiscal revenues (€3bn). On the revenue side, the fight against tax evasion and fraud will recover around €1.8bn; while the effort to reduce expenditure will be divided between the general government accounts (€9bn) and the social security accounts (€6bn).

Although the nominal deficit for 2013 has been revised upward (0.2 points to 4.1, following the 4.9% in 2012), the fiscal consolidation for this year is maintained practically unchanged. The structural deficit has fallen year after year since 2010, thanks to a major fiscal consolidation effort that has cut the deficit to 2.6% of GDP from 6.1% in 2010. In 2014 we expect the structural deficit to be around 2.2% of GDP and the nominal figure to be around 3.6% (after 4.1% in 2013). Overall, we continue to forecast that the structural budget balance will be reached in around 2016; but we maintain our forecast of a nominal deficit of under the 3% in 2015.

Italy

The draft 2014 budget revises slightly upward the fiscal deficit forecast for 2013 (Chart 17), which is now set at 3% following the forecast of 2.9% presented to the Commission in May. This target could be achieved by the government introducing minor fiscal adjustments for the rest of the year.

For 2014, the government expects a nominal deficit of 2.5%, without changes with respect to the figure presented before to the European Commission. As in other countries, this budget shows the attempt to restructure the fiscal adjustment from increased taxes to expenditure cuts. For next year fiscal measures worth €11.6bn are expected (0.7% of GDP) , of which 33% will come from expenditure cuts, 13% from higher fiscal revenue, and the rest divided between one-off measures (mainly privatizations) and others whose result is debatable (the fight against fraud and tax evasion).

The fiscal effort in Italy will have amounted to 2.9% of GDP in the period 2010-2013. As a result, the structural deficit will be around 1.7% in 2013. In addition, in 2014 we estimate that the structural deficit will continue its path toward a balanced budget reaching 1.4% of GDP in that year, so a structural budget balance can be expected from 2016.

Portugal[3]

Greece

The Greek government presented the draft budget for 2014 to its parliament on October 7. Under the proposal, the central government is expected to collect 4.6% more in 2014 (up to €54.4bn) and expenditure to fall by 4.7% (to €56.4bn), thus achieving a central government deficit of €1.9bn (1% of GDP), compared with the €7bn (3.9% of GDP) estimated for 2013.The deficit of all public administrations in 2014 is expected to remain at the 2013 levels (2.4% of GDP). Moreover, the primary balance will increase in 2014 (+2.9% of GDP after +1.9 in 2013).

3: See Box 4

These official forecasts are based on an assumption that the GDP will contract by 4% in 2013 and that in 2014 there will be a slight growth of 0.6%, with negative inflation in both years. The public debt is expected to fall to 174.5% of GDP in 2014 from the figure of 175.5% in 2013.

In any case, the Troika is negotiating with the government on the details of the 2014 budget and there are still differences in the assessment of the funding needs and the adjustments needed for accomplish the fiscal target.

Ireland

The latest data for budget execution available through October indicate that Ireland should meet its fiscal deficit target of 7.3% of GDP for 2013. The preliminary budget for 2014, presented in mid-October also assumes that the deficit will fall to 4.8% next year.

The main new point in the preliminary budget is the relaxation of the fiscal effort in 2014 from the 1.8% initially planned to 1.5% (€ 2.5bn). Of this total, 64% will come from expenditure cuts and the remaining 36% from increased taxes.

The adjustments to public expenditure on health dominate fiscal consolidation in 2014, accounting for around half the total programmed cuts. On the revenue side, mainly highlights the introduction of a tax on financial institutions to cover the period 2014-2016, also the increase in the tax on interest on savings and the reduction in the tax allowance on medical insurance premiums.

All these measures will allow the structural deficit go down until 3.6% (from the estimated 5.2% in 2013), then hover around 2% in the period 2015-2018.

Spain

The results observed in the first eight months of the year may be insufficient to ensure compliance with the stability target. Although the consolidation policies are expected to continue, there is a growing likelihood that those that have been announced so far are barely sufficient to offset the negative effects of the economic cycle and the increased cost of servicing the debt. As a result, the deficit at the end of the year would be at the same level as at the end of 2012, around 6.8% of GDP, 0.3 pp above the stability target.

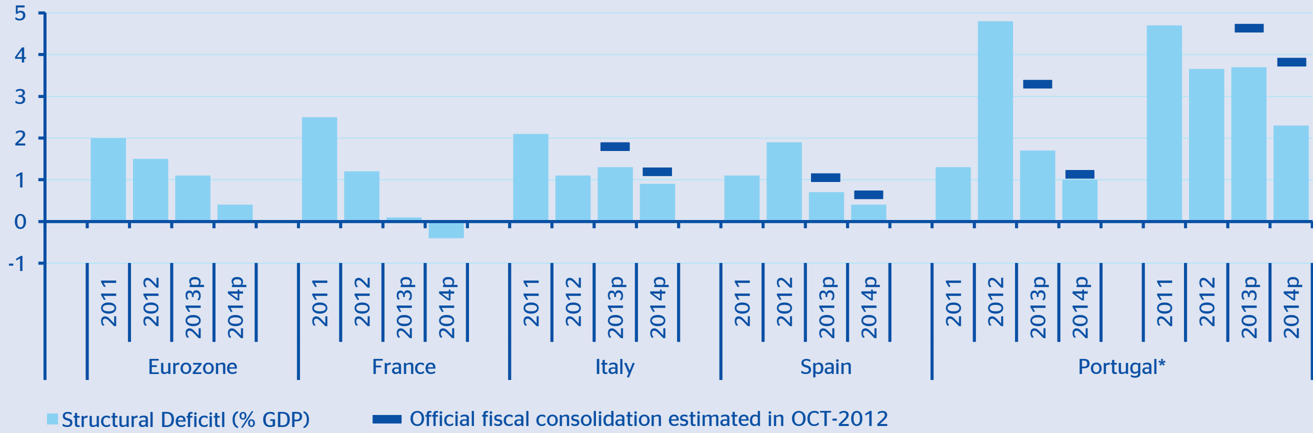
The draft state budget for 2014, approved by the Government in September, continues with the consolidation policies undertaken in previous years, without introducing any major changes in this respect. Thus the revenue forecasts are reasonable, given the combination of a credible macroeconomic scenario that is in line with BBVA Research and the lack of tax increases. Discretionary government expenditure will continue to fall, offsetting the expected increase in pensions and unemployment benefits.

In any event, the fiscal policy stance contained in the 2014 budget will be considerably less constrictive than in previous years, consistent with the moderate recovery that is expected. Overall, this makes the overall deficit target for 2014 (5.8% of GDP) credible, provided the deviation from the 2013 target (6.8% of GDP) is not too significant.

In this context, if our expectations are met, the Spanish public administrations will register in 2013 a primary structural surplus that would increase to 2% of GDP by the end of 2014, accumulating a correction of 6.7 percentage points since 2011.

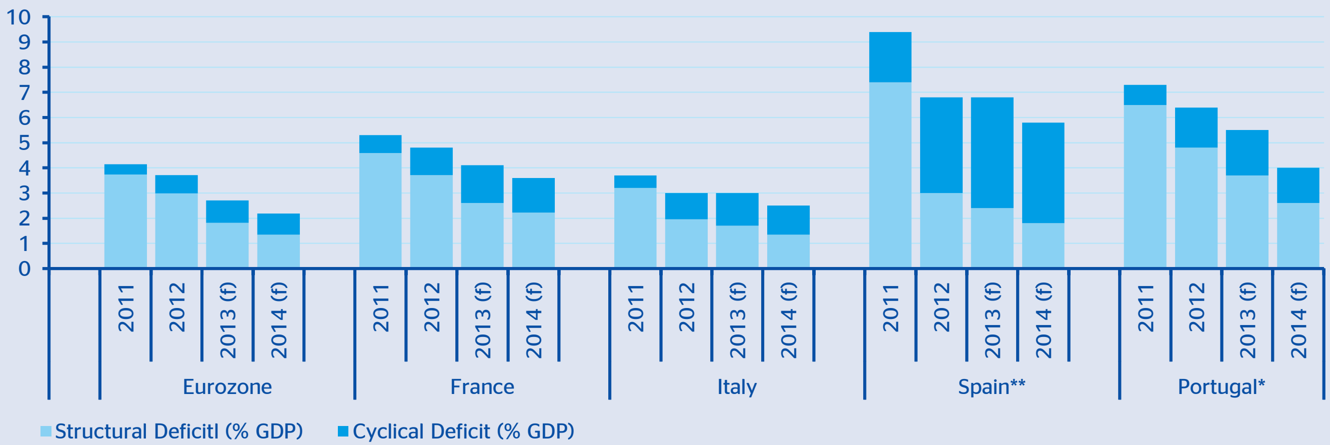
With the budget submitted to Brussels the government has confirmed the measures it announced at the end of September. The budget plans to increase revenue by €2.1bn in 2014 and cut expenditure by €1.9bn. The bulk of the adjustments will be generated from fiscal adjustments already applied; with a significant saving of €1.6bn-1.7bn that come from the freeze on public-sector salaries.

Chart 16
Fiscal consolidation 2011-2014



* Portugal: One-off measures and the bailout of the financial sector are excluded.
Source: Haver analytics and BBVA Research

Chart 17
Fiscal Deficit 2011-2014



** Portugal: One-off measures and the bailout of financial system are excluded.
** España: Financial system bailout is excluded.
Source: Haver analytics and BBVA Research

4. Outlook: slow recovery supported by domestic demand

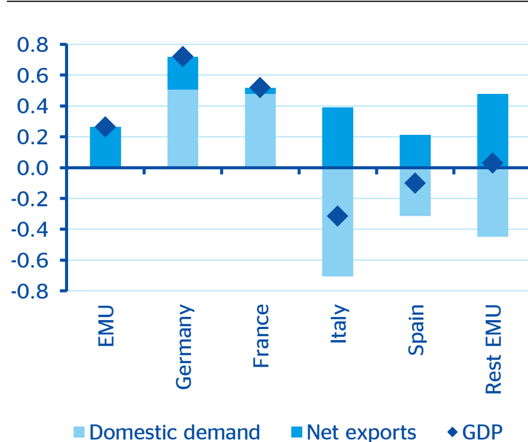
The Eurozone emerged from recession in 2Q13, driven by an increased strength of domestic demand

The eurozone's GDP grew by 0.3% q/q in 2Q13, slightly above expectations, and also showed a more balanced pattern of growth. As we projected three months ago, exports once again grew (2.1% q/q) following the decline seen in previous quarters, and did so more than imports (1.6% q/q), despite the latter reflecting more buoyant domestic demand, resulting in a 0.3pp contribution from net exports to GDP growth.

The main surprise was the improved performance of some of the components of domestic demand, especially investment and public consumption. Investment rose 0.2% q/q following the strong declines registered since mid-2011, somewhat more than the improvement envisaged in our forecasts (-0.3% q/q), which already factored in the disappearance of the temporary adverse effects at the start of the year. This suggests a widespread improvement in all the components of investment, and not only construction-related investment. Public consumption also surprised upward, with a growth of 0.4% q/q after remaining practically stagnant in previous quarters. It could be responding in part to the change in the mood of fiscal policy.

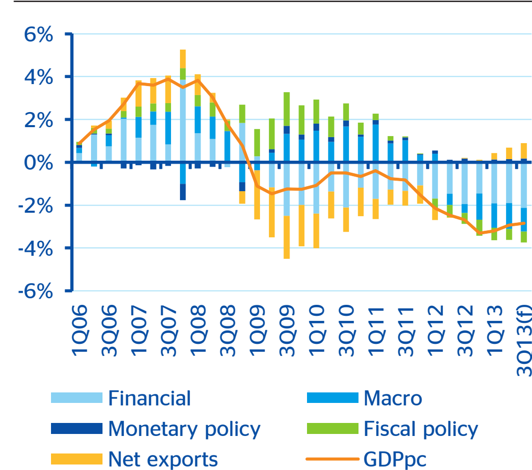
Finally, private consumption also grew again in 2Q13 at a very moderate pace (0.1% q/q as we forecast), interrupting the significant falls in previous quarters, and supported by improved consumer confidence, some stabilization in the labour market so far this year and moderation in inflation, which was reflected a gentler fall in real disposable income (down 0.5% in the first half of the year after a fall of 1.1% last year). In short, despite the fact that the change in inventories subtracted 0.2pp from quarterly GDP growth (and offset the previous positive surprises), domestic demand did not drain growth (0.0pp, as we forecast), after having weighed on economic activity for two years. (Chart 18).

Chart 18
GDP growth (% q/q) and contributions in 2Q13



Source: Eurostat and BBVA Research

Chart 19
EMU: decomposition of GDP per working age population (cyclical component)



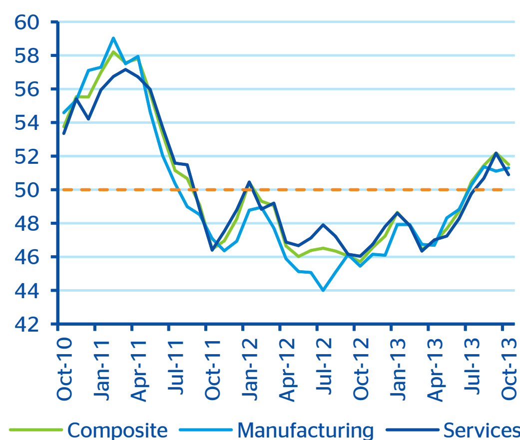
Source: BBVA Research

Analysing the structural factors[4], the reasons for the upturn in GDP in 2Q13 appear to be both the looseness of fiscal targets decided in the spring and the maintenance of monetary policy by the ECB, while the support provided by net exports is still fundamental. The financial shocks once more weighed on growth, basically those involving the credit squeeze and its impact on investment (Chart 19).

The countries in central Europe led the recovery, while the recession eased significantly in the periphery

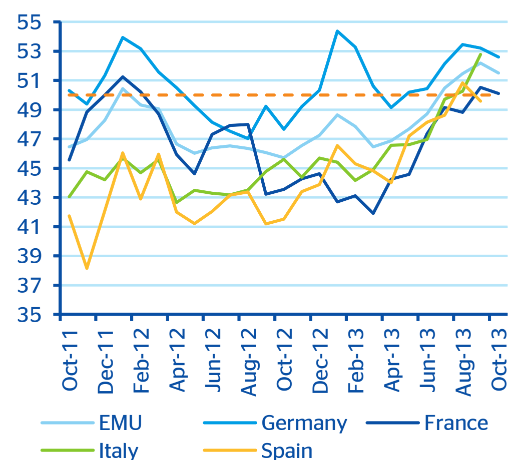
GDP in both Germany and France bounced back sharply in 2Q13 with an increase of 0.7% q/q in Germany and 0.5% q/q in France, providing an upward surprise especially in the latter (our forecasts were for 0.5% and 0%, respectively). The recession eased significantly in Italy (-0.3% q/q after -0.6% q/q in 1Q13) and in Spain (-0.1% q/q after -0.5% q/q in 1Q13), in line with our scenario. In general, the performance of the components of domestic demand, above all private and public consumption, was responsible for these differences in GDP growth across member states, contributing positively in the countries of northern Europe, and draining growth in the periphery. Support from exports was widespread, with a higher net contribution of the foreign sector in the periphery (thanks in part to the weakness of imports) (Chart 18).

Chart 20
EMU: PMI confidence survey



Source: Markit Economics and BBVA Research

Chart 21
EMU: PMIs by country



Source: Markit Economics and BBVA Research

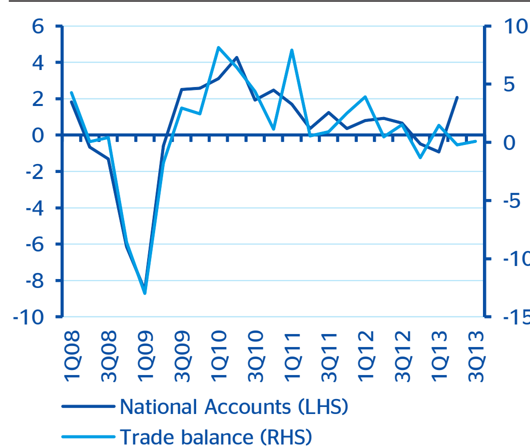
The recovery consolidates in the second half of the year and extends to the periphery…

Confidence indicators for 3Q13 as a whole show that recovery is underway, including in the peripheral countries. In particular, the results of both the European Commission's survey and the purchasing management indices (PMIs) improved significantly and above expectations in July and August, with a somewhat more moderate growth in September. Despite the positive surprises, the data for September and preliminary data for October suggest that the pace of recovery in the eurozone could be stabilising. In addition, the improvement in these indicators has been widespread by sector (Chart 20), in line with the more balanced growth already seen in the second quarter, with the recovery of exports already boosting strong domestic demand, especially in investment.

4: 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

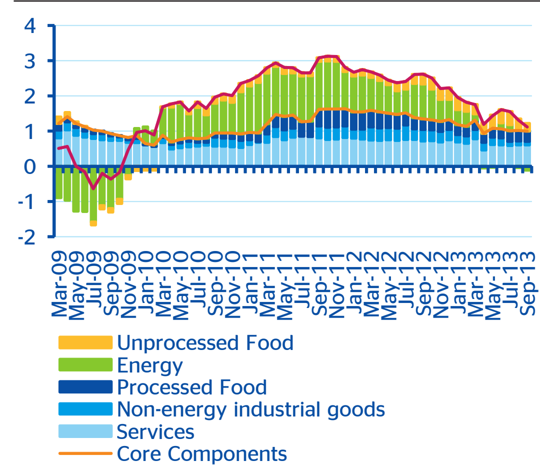
Across countries, the improvement of these indicators was greater in the periphery (Chart 21), continuing with the trend already seen in the second quarter. Specifically, the PMIs for Italy and Spain have already risen above 50 points and suggest a certain stabilization of their economies, or even weak growth, in the third quarter.

Chart 22
EMU: Exports (% q/q)



Source: Eurostat and BBVA Research

Chart 23
EMU: HICP inflation (% y/y) and contributions by component



Source: Eurostat and BBVA Research

Nevertheless, the activity indicators (still partial), do not show such positive signs, and are more in line with a weak and slow exit from recession The most worrying signs come from the data on industrial production available through August, which show that activity in the sector in the eurozone as a whole has stagnated since its upturn in 2Q13. This behavior is due to the significant slowdown in Germany and the drop in activity in France, while countries in the periphery appear to be building up an incipient recovery. In addition, soft data continue to show a more optimistic outlook in manufacturing industry, with foreign demand as the main pillar of support. The slow recovery of industrial output, together with extensive unutilized firms' capacity and a credit squeeze in a context of falling business earnings, anticipate very moderate investment growth.

Data are somewhat more optimistic for household expenditure. Retail sales continued to increase in August and suggest that the pace of private consumption registered in 2Q13 could continue or even accelerate slightly in the second half of the year. The increase in household spending is reflecting the significant improvement in consumer confidence in recent months, supported mainly by the stabilization of the unemployment rate so far this year (around 12%).

The data from the foreign sector (seasonally adjusted) suggest that exports to August still support growth (Chart 22), and given the expectations for robust global demand over the coming quarters (despite a slight slowdown in emerging markets), they are expected to be determinant for the rest of the year. However, imports are also growing, although at a slower rate, and this trend is expected to continue in the coming months, supported by more buoyant domestic demand. It is thus likely that the positive contribution from net exports has declined slightly.

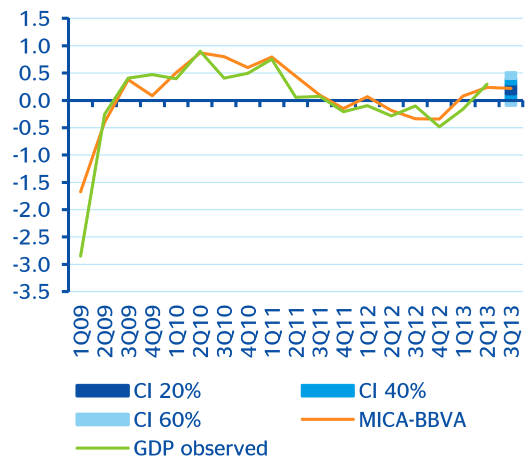
... with a relatively steady growth, as stabilization in the periphery will offset the slowdown in the north of Europe

Taking into account all this information, our short-term model for GDP (MICA-BBVA[5]) suggests that the recovery is still in progress, although at a somewhat more moderate pace. We estimate a quarterly growth for 3Q13 of 0.2% q/q (Chart 24). Although this estimate is below that included

5: 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

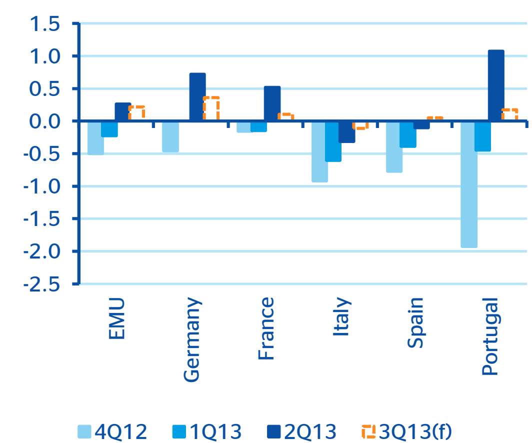
in our forecasts three months ago (0.3% q/q), it does not represent a change in the pace of exit from the recession. The moderation in the quarterly growth rate would basically be due to the disappearance of some of the temporary factors that supported the upturn in growth in 2Q13 (above expectations) in some core countries in Europe, particularly France and Germany (investment in construction and inventories), and it was already included in our scenario.

Chart 24
EMU: MICA-BBVA and GDP observed (% t/t)



Source: Eurostat and BBVA Research

Chart 25
GDP growth (% q/q)



Source: Eurostat and BBVA Research

Specifically, we now expect that economic growth in Germany and France will slow down in 3Q13 to 0.4% q/q and 0.1% q/q (from 0.7% and 0.5%, respectively), while the peripheral countries could either already be emerging from recession (Spain: +0.1%; Portugal: +0.1% or +0.2% q/q), or have stagnated (Italy: -0.1%/0.0% q/q (Chart 25).

Finally, the limited data available for the fourth quarter (PMIs) were disappointing in October, although consistent with a continued slow and moderate upturn. With very few data and the inertia of other variables, our MICA-BBVA model estimates a quarterly GDP growth of around 0.3% q/q in the last quarter of the year.

Inflation slowed again in the third quarter

After remaining stable in July, inflation fell by 0.9pp between August and October to 0.7% y/y, due mainly to falling prices in the energy component (around -0.4pp), but also to moderate increases in food prices (around 0.4pp), while inflation in the services and non-energy industrial goods components remained practically stable in the third quarter, with services moderating slightly to 1.2% y/y in October (around -0.1pp). Although we still do not have the final breakdown for October, this would represent a slight slowdown of core inflation to 1% y/y from 1.3% y/y three months ago. For the coming months, our forecasts expect a slight increase in headline inflation of around 0.2pp or 0.3pp through December due to the reduction of the base effect of energy prices, while core inflation should remain broadly stable.

After contracting in 2013, the eurozone will grow slightly under its potential in 2014

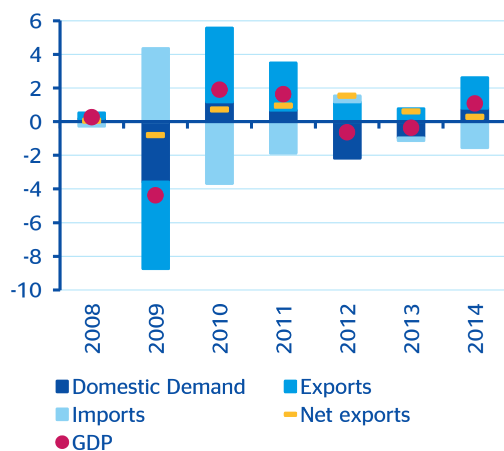
As explained above, in the last three months the economy performed generally in line with our estimates, partly reflecting how the management of the crisis in the eurozone as a whole was also in line with the assumptions included in our scenario (mainly the slow progress toward banking union, limited impact of the adverse events in the periphery on financial tensions and loosening of fiscal consolidation).

This positive knock-on effect (up 0.1pp), both of the slight upward surprise in growth in the second quarter and the upward revision of the data for the first quarter (to -0.2% q/q rather than the initially estimated -0.3%) are now offset by lower forecast growth for the third quarter. This also does not represent any change in our view of a very slow and steady recovery over the coming quarters. As well as maintaining our assumptions with respect to economic policy, as we pointed out in Section 3, there have also been no significant changes in the rest of the fundamentals that underlie the continued recovery.

Overall, we maintain our growth estimate for the whole of the eurozone in 2013 and 2014 unchanged, at -0.4% and 1.1% respectively, still below potential. It means that GDP will still be around 1% under the pre-crisis levels of 2007 at the end of 2014.

Chart 26

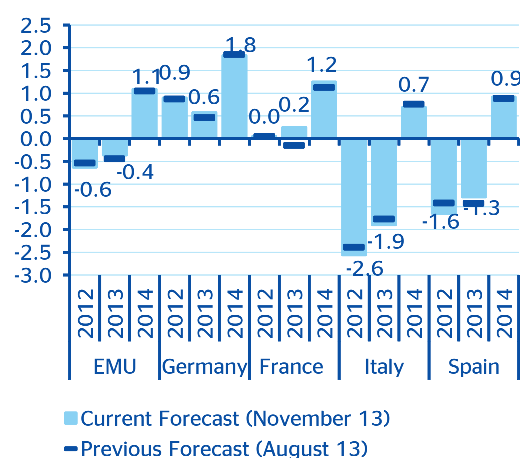
EMU: Annual contribution to growth (pp)



Source: Eurostat and BBVA Research

Chart 27

EMU: Growth forecasts by country



Source: BBVA Research

The incipient recovery of domestic demand will become stronger in 2014

Given the slow correction and recovery of the fundamentals of domestic demand, we only expect it to improve gradually and moderately in the second half of the year. In 2013 as a whole its contribution to growth will be negative (-1pp), although lower than in 2012 (-2.2pp) and with an upward trend. The incipient recovery will strengthen in 2014. Domestic demand will make a positive contribution of 0.8pp and should take over net exports as the driver of growth, with exports falling from 0.6pp in 2013 to 0.3pp in 2014) (Chart 26).

The stabilization in the labour market expected for the forecast horizon will result in real household disposable income falling less this year (round -0.6%, compared with nearly -2% in 2012, supported above all by more moderate inflation), and remain practically flat next year. Consumer confidence will also improve, which should allow a steady reduction in the saving rate (to around 12%), above all for precautionary reasons. Both factors will be the main reasons behind the recovery of household spending that began at the start of this year. In addition, progress toward banking union and the restructuring of the sector already carried out in some countries of the periphery could contribute to eliminating financial restrictions, which will allow a sustained increase in consumer credit. In all, our forecasts suggest a slow growth in consumption in the second half of the year (around 0.1%/0.2% q/q), which will gather pace in 2014, above all in the second half of the year. As a result, after contracting by -0.5% in 2013 private consumption will grow by 0.7% in 2014.

… but a boost is still needed to investment from global demand

Despite the weakness of domestic expenditure, the strength of global demand and thus of exports continues to be key for supporting expectations of future corporate demand and reducing uncertainty, thus leading to increased investment. However, our estimates still suggest a slow recovery, due to excess capacity in companies and tight credit conditions and high funding costs in an environment of reduced corporate earnings (fall of around 1.5% y/y since the middle of last year), and of lower prices of the assets that could be used to obtain this funding. In addition, the process of restructuring the public balances will still affect some of the investment items (above all construction). Overall, the slight growth already observed in 2Q13 and that forecast for the second half of this year will not stop investment from falling in 2013 as a whole (down 3.6%), similar to last year, although the pace of investment will increase over next year to over 2% in 2014.

Due to the need to guarantee the sustainability of the public accounts, there is little room for maneuver for use of fiscal policy as a stabilising tool in most countries. However, the relaxation of the fiscal targets in a number of member mtates could mean that public consumption will not drag down growth in the forecast horizon (as seen in 2011 and 2012). Our scenario includes a slight growth of public consumption in both 2013 and 2014 (0.2% and 0.4% respectively). As a result, the public deficit for the whole of the eurozone could fall by 0.9pp to 2.8% of GDP in 2103 and 0.4pp to 2.4% of GDP in 2014, which would mean an increase in the public debt to 94.5% and 95% of GDP in each of these years.

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

Exports once more rose in the second quarter in line with our forecasts, and even more than expected, confirming that the falls recorded at the end of last year and the start of this were basically due to the temporary moderation of demand from some of the main trading partners. The positive surprises observed in the second quarter, together with the data on the trade balance available for the third quarter, and our maintaining the trend in the main determinants of exports (a robust global growth forecast and some weakening of the euro in the forecast horizon) mean that we have revised the growth forecasts for exports up slightly for 2013 to 1.7% and maintained the rate for 2014 practically unchanged (up 3.9%). However, now we also expect a slight growth in imports in 2013 (up 0.4% from -0.5%) as a result of stronger domestic demand, as well as a greater need for intermediate consumption to meet foreign demand, and we continue to expect them to gain momentum next year (up 3.7%). Despite these revisions and the key role of exports, above all in the recovery of investment, the positive contribution of net exports to growth will be clearly be reduced in 2013 (+0.6pp) and 2014 (+0.3pp), after an average contribution of more than +1.1pp following the 2008 crisis.

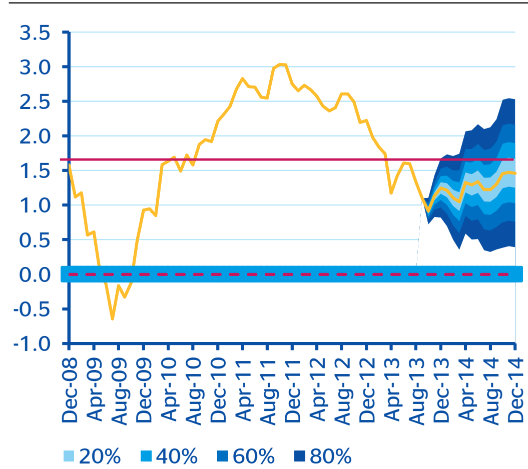
A flat active population stabilises the unemployment rate at 12%

Despite the unemployment data showing an interruption in the deterioration in the labour market, with the unemployment rate stabilising at around 12% since the start of the year, this trend has been the result of a reduction in the active population (down 0.2% q/q in 1Q13 and 0% in 2Q13), which offset the destruction of jobs in the first two quarters of the year (down 0.4% q/q and 0.1% q/q, respectively). Nevertheless, the increase in activity in 2Q13 appears to be reflected already in the number of workers falling less sharply.

In this scenario, and given the delayed impact of economic growth on employment, our forecasts suggest that it will not be until next year that some jobs will be created, when the stronger recovery clears away business uncertainty with respect to hiring new workers. We still expect a slight fall in workers in the second half of this year. As a result, we now expect employment to fall by 0.9% in 2013 (slightly above the figure of -0.7% in 2012) and be more or less stable in

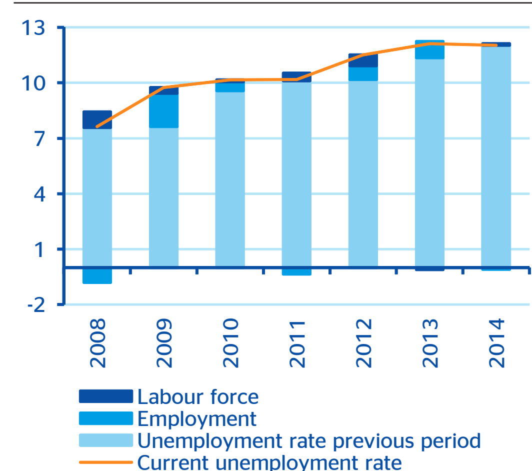
2014 (+0.1%). However, as a result of the slowdown in growth of the active population, which we expect to remain practically the same in the forecast horizon (-0.1% in 2013 and +0.1% in 2014), the unemployment rate will remain stable at 12% for the whole of next year (after increasing more than 4pp since 2008), and it will not be until 2015 that it begins to drop steadily (Chart 29).

Chart 28
UEM: inflación (% a/a)



Fuente: Eurostat y BBVA Research

Chart 29
EMU: unemployment rate and factors



Fuente: Eurostat y BBVA Research

The recovery in the periphery will gain traction in 2014 and grow at a pace close to the core eurozone

With minor variations from our forecasts for the eurozone as a whole, we have only revised our estimates for some of the countries in the zone (Chart 27), basically France and to a lesser extent Germany due to the positive GDP growth surprises in the second quarter. However, these surprises basically responded to a bigger upturn in activity following the disappearance of some adverse temporary factors in previous months, or determinants that are unlikely to be sustained over time, so the changes are minor. We now expect quarterly GDP growth in the French and German economies to slow in the second half of the year to a rate more in line with their growth fundamentals and our forecasts of three months ago. We still expect an incipient recovery in the periphery, which will gain momentum over next year and grow at similar rates to those forecast for the core countries of the eurozone.

Despite this, these forecasts mean that while the level of real economic output in Germany and France will be clearly above pre-crisis levels in 2014 (5.4% and 2.2% higher, respectively), this level will be clearly lower in Italy, Spain and the rest of the eurozone (-7.4%, -6% and -4.3%, respectively).

We now expect the German economy to grow this year at 0.6% (an upward revision of 0.1pp compared with our scenario three months ago), and somewhat below the figure in 2012 (up 0.9%), thanks to the relative strength of the fundamentals of its domestic demand. For 2014, we expect this growth pattern to be maintained and lead to a relatively stable GDP growth (around 0.5% per quarter), with a rise of 1.8% for the year as a whole.

In France, there has been greater resilience of domestic demand than anticipated three months ago, above all public and private consumption. Despite the fact that we have already discounted the greater breathing room for growth offered by relaxed fiscal targets, we have revised upward our forecast for this year, and now expect a slight increase of 0.2% for 2013 (compared with the flat figure forecast in August). This should pick up to 1.2% in 2014.

With respect to the periphery, there are few surprises over the last three months, although the countries will continue to correct their economic imbalances and address the fragmentation of their financial markets. Although this fragmentation is being reduced, it will keep financing costs high at least in the short term. All this will only allow an incipient and very moderate recovery in the second half of 2013, which will pick up over next year and grow under the estimate for the eurozone as a whole in 2014. Both the Italian and Spanish economy will contract this year (-1.9% and -1.3% respectively) and grow in 2014 by 0.7% and 0.9%.

Inflation will remain clearly below the ECB target throughout the forecast horizon

After the major slowdown in inflation over recent months to 0.7% y/y in October, our forecasts point to a slight acceleration by year-end to around 1.1% y/y in December, as a result of the disappearance of the base effect of energy prices, while core inflation will remain relatively stable at current levels (1.0%/1.1% y/y). As a result, we maintain our forecast for both headline and core inflation for 2013 as a whole at 1.5% and 1.4% respectively, with some downside risks derived from lower energy and food prices, which are offset with a possible greater impact of the tax hike in Italy in October.

For 2014, inflation should remain relatively stable given the lack of inflationary pressures on the supply or demand side, as we do not expect additional tax measures that could affect consumer prices, while the improvement of the labour market will be only gradual.

Although the uncertainty regarding some exogenous (commodity prices) and/or discretionary variables (administered prices, taxes) is still high and they could put upward pressure on prices, the risks of this scenario are tilted to the downside, derived basically from the negative surprise in inflation in October. The October figures could reflect a greater impact of the internal devaluation process being carried out in peripheral countries, as well as the recent appreciation of the euro. However, the probability of recording negative annual inflation rates in the forecast horizon is still very limited (Chart 28).

Eurozone member states: detailed analysis

Germany: recovery led by the strength of domestic fundamentals

GDP: +0.6% in 2013 +1.8% in 2014 HICP: +1.7% in 2013 +1.8% in 2014

Latest official figures for 2Q13: despite having already factored in a rebound in activity in 2Q13 following the disappearance of some adverse temporary factors in the previous two quarters (a slowdown in global demand and poor weather), 0.7% q/q GDP growth was an upside surprise (BBVA Research: +0.5% q/q), providing further evidence of the strength of domestic factors, and also support from foreign demand. In particular, construction investment bounced back strongly (2.6% q/q following -1.3% q/q in 1Q13), explaining a little more than 0.4pp of quarterly GDP growth. There was also moderate growth of around 1% q/q in all other investment categories, whilst private (+0.5% q/q) and public (+0.6% q/q) consumption both grew strongly, continuing the trend begun in mid-2012. This stronger than expected increase in demand was reflected in falling inventories, which drained 0.2pp from GDP growth, holding the contribution of domestic demand back to 0.5pp (+0.2pp in 1Q13). Finally, exports began to grow again (+2.2% q/q), increasing by more than imports (+2% q/q), and thus resulting in net exports making a positive contribution to GDP growth ((+0.2pp following -0.2pp in 1Q13 and -0.5pp in 4Q12).

3Q13 and 4Q13 forecasts: indicators released to date point to the recovery slowing in 3Q13 to a rate more consistent with the economic fundamentals, and closer to our forecasts three months ago (BBVA Research: +0.4% q/q). Firstly, confidence indicators improved significantly in July and August, stabilising in September with a slight fall in October. These indicators do not, in general, reflect the rebound in activity in 2Q13, as this was due to temporary factors, and also, despite the increase, these indicators have stabilised at levels consistent with average growth in the German economy (around 0.3%-0.4% q/q). These confidence surveys also continue to show that the improvement in expectations is based mainly on the strength of domestic factors, as shown by the strong increase in the contribution of services and by the weaker improvement in industrial sector expectations being based more on domestic than foreign orders. Moreover, hard activity indicators are also pointing in this direction. Industrial output figures to August -both including and excluding the construction sector- show the sector slowing (0.6% in 2Q13 from 1.5% q/q), although still in line with consolidation of the recovery in industrial output over the coming months; this will boost investment. Retail sales continue to reflect the increased confidence of economic agents, together with a strongly performing labour market (unemployment down by around 0.2pp since the start of the year) and recent salary increases (2.1% q/q in 2Q13), remaining stable to September and suggesting that private consumption will continue supporting growth. Finally, and on a less optimistic note, figures for the export sector show a slight fall in exports, while imports are holding up. This suggests that the net exports contribution could once again ease, also being responsible for the expected slowdown in growth. Although 4Q13 figures are limited to confidence surveys for October, and it is too soon to draw conclusions, this is consistent with our forecast that current growth levels will be sustained (+0.5% q/q).

Growth outlook for 2013 and 2014: our forecasts continue to point to a solid recovery of the German economy over the forecasting horizon, supported by improving domestic demand. However, the higher than expected growth in 2Q13 has led us to revise our growth forecasts for the full-year 2013 by +0.1pp to 0.6%, while we leave our 2014 forecast unchanged at 1.8%. The sustained improvement in the labour market, growing salaries, moderate inflation and declining financing costs should lead to faster growth in household consumption in 2013 and 2014, at 1.1% and 1.4%, respectively. Better expectations for domestic demand and the strength of global growth, along with the availability of funding, should be enough to support a rebound in investment, particularly in 2014 (4.1% following -1.1% in 2013). Furthermore, the soundness of public finances should allow for neutral fiscal policies. The recovery in domestic demand should trigger greater dynamism from imports, which would offset the contribution to growth from net exports (-0.1pp in 2013 and 0pp in 2014, after 1.1pp in 2012).

Inflation outlook: the rebound in inflation at the end of 2Q13 and in early 3Q13 to 1.9% y/y was due to increases in both energy-price and core inflation. However, the former should have slowed in August and September due to the base effect of price rises one year previously, keeping general inflation at 1.6% and core inflation stable at 1.5% y/y. Over the coming months, we expect core inflation to remain relatively stable or rise again slightly. This is due to increased domestic demand and also because higher labor costs will be somewhat passed on to end 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%, holding relatively stable in 2014 (1.8%), while remaining above the average inflation expected for the eurozone 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 higher 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. We expect the budget to be in balance again in 2014 (0% of GDP). As a result, public debt should begin to come down slightly this year (after holding relatively stable at around 82% of GDP since 2010), to fall somewhat below 80% of GDP, standing at around 77% in 2014.

France: the postponement of the fiscal adjustment will prevent the economy from contracting in 2013, returning to moderate growth next year

GDP: +0.2% in 2013 1.2% in 2014 HICP: +1.1% in 2013 +1.3% in 2014

Latest official figures for 2Q13: France returned to growth in 2Q13, growing faster than expected (0.5% q/q; BBVA Research: 0%) and having contracted in the two previous quarters. This was due mainly to increased private sector spending (with a 0.4% q/q increase in private consumption and a slowdown in the rate of decline of investment to -0.4% q/q), based on stabilization in the labour market and increased disposable income and company profits, also supported strongly by public consumption (+0.7% q/q). This, together with increased inventories, resulted in domestic demand making a positive contribution to quarterly GDP growth of +0.5pp. This improvement in domestic demand, together with a rebound in exports (+2% q/q having contracted by 0.5% q/q in the two previous quarters), was also reflected in increased imports (1.7% q/q, following the weakness observed over the last year and a half), resulting in net exports making no overall contribution.

3Q13 forecasts: the latest figures point to the economy having grown slightly in 3Q13, but at a much slower pace (+0.1% q/q). Confidence indicators increased in the third quarter, particularly the PMIs, which exceeded 50 points; although this improvement was widespread across sectors, it was more intensive in the services sector, suggesting that domestic demand will continue providing the main support for the recovery. In particular, retail sales to August returned to growth (1.7% in 2Q13, following 0.7% q/q); this suggests that, whilst it still remains weak, private consumption may have increased slightly over the quarter. Nevertheless, industrial production to August fell significantly (-1.5% in 2Q13, following +1.2% q/q), suggesting, along with uncertainty over the consolidation of the recovery and future demand, that there will no increase in investment in the short term. Finally, trade balance figures to August suggest that net exports may have again undermined overall quarterly growth, with exports falling (-0.9% in 2Q13) whilst imports remained practically constant (0.4% in 2Q13). There are very few figures yet for 4Q13 (October confidence indicators), but these point to activity slowing and downside risks to our +0.3% q/q forecast for the end of the year.

Outlook for growth in 2013 and 2014: although we have not changed our opinion of the fundamentals underlying the slow but gradual recovery in France, the positive surprise in 2Q13 has led us to revise our forecast for the year as a whole upwards by 0.3pp to 0.2%. In particular, our forecasts suggest that the confidence of economic agents will continue to improve, as the postponement of fiscal reforms will continue increasing the disposable income of consumers (who will also benefit from moderating inflation) and corporate profits, which will be reflected in increased investment and a stabilized labour market. Therefore, private consumption will grow slightly in 2013 (+0.3%, after -0.3% in 2012), growing by around 1% in 2014. This improvement in domestic demand will be reinforced by faster export growth over the year, and this, along with good financing conditions, will end up driving investment, which should rally in 2014 after the drop anticipated this year (-2.1% in 2013 and 1.7% in 2014). The gradual improvement in domestic expenditure (0.1pp in 2013 and 1.1pp in 2014), also supported by growth in public consumption (1.5% in 2013 and 0.6% in 2014), will lead to growth in imports, particularly in 2014 (0.6% in 2012 and 3.3% in 2014), with the positive contribution from net exports reducing (0.2pp in 2013 and 2014, after 1pp in 2012).

Inflation outlook: for 3Q13 as a whole, both core and general inflation will increase slightly, by around 0.2pp on the previous quarter, remaining relatively stable at 1% and 0.9% y/y, respectively, in line with our forecasts, bringing to a halt the rapid slowdown in inflation since the end of last year. Given the expected economic outlook, and with domestic demand remaining relatively resilient, inflation will remain stable over the coming months. We are maintaining our forecasts for the average annual inflation rate in 2013 and 2014, at 1.1% and 1.3%, respectively.

The public sector: this year's nominal deficit has been adjusted upwards slightly (4.1% of GDP from 3.9% previously), following the relaxation of fiscal consolidation announced by Brussels in May of around 0.5pp of GDP to 1.4% in 2013. The 2014 deficit stays at the 3.6% announced at the start of the year. Public debt will increase from 90.2% in 2012 to 93.4% in 2013, further increasing in 2014 to 95.1% of GDP.

Italy: : net exports will continue to provide the main support for the weak recovery expected at the end of the year, with moderate growth in 2014

GDP:- 1.9% in 2013	0.7% in 2014	HICP: +1.4% in 2013	+1.7% in 2014

Latest official figures for 2Q13: the recession eased off in the second quarter (-0.3% q/q following -0.6% q/q in 1Q13), as expected (BBVA Research: -0.3%; Consensus: -0.4%), due mainly to support from net exports (+0.4pp following an average quarterly contribution of around +0.3pp in 2012 and -0.3pp in 1Q13), whilst the pace of deterioration in components of domestic demand slowed slightly, with the exception of inventories (-0.4pp following +0.3pp in 1Q13). The fall in private consumption, -0.4% q/q following -0.5% q/q in 1Q13), together with tight credit conditions, impacted more on business decisions than improved export sales and an interruption to the fall in business profits (0% q/q following -0.4% q/q in 1Q13); this in turn impacted on investment, although less strongly (-0.3% q/q following -2.9% q/q in 1Q13).

3Q13 forecasts: confidence surveys are giving off mainly positive signals. The improvement in European Commission indicators points to a slowdown in the contraction of GDP in 3Q13 and PMIs continued to increase for the second consecutive quarter, breaking through 50 points in September, driven by an improved outlook for export orders as reflected in figures for industrial output to August. In general, the available data suggests that the decline in activity will have continued to slow, in line with our forecast of GDP contracting -0.1% q/q, undermined still by weakness in domestic demand but buoyed, again, by a positive contribution from net exports. We have already seen signs of some resilience from factors underlying household consumption. Inflation has declined significantly since late 2012 (-0.8pp in 4Q12, -0.6pp in 1Q13, -0.8pp in 2Q13 and -0.2pp in 3Q13) and, along with the absence of fresh tax increases following confirmation of the cancelation of the Single Municipal Tax on First Homes, this will continue to drive up real disposable household income, although at a moderate pace given the ongoing deterioration of the labour market. This is already showing in the retail sales figures available to August, 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 3Q13. On the other hand, trade balance figures suggest that net exports continue contributing to containing the decline in GDP, although less than in 2Q13, mainly due a larger increase in imports, as there is yet to be a clear improvement in exports. However, a rebound in industrial orders from abroad points to a sustained improvement in exports over the next few months, which seems likely to be the only driver of growth in the short term. This is particularly because the timid improvement in exports will not be enough to encourage investment over the rest of the year, given the ongoing deterioration in corporate profits along with unused capacity at companies and high financing costs.

Outlook for growth in 2013 and 2014: we continue to expect slight growth in 4Q13, picking up pace somewhat next year, with overall GDP growth this year of -1.9% and 0.7% in 2014. By components, in 2013 domestic demand may drain -3.0pp from GDP, as we expect a substantial contraction in investment (-6.0%), but also in private (-2.6%) and public consumption (-0.8%). As for foreign demand, a positive contribution of 1.1pp 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).

Inflation outlook: as we anticipated three months ago, inflation eased significantly over the third quarter, particularly headline inflation, due to a drop in energy prices. Specifically, inflation has come down by around 2.8pp since mid-2012 to 0.9% y/y in September, while core inflation declined 1.2pp to 1.3% y/y, as the impact of 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 average annual inflation of 1.4% 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 come in at 1.7%, due to the October 1 VAT increase.

Public sector: the 2013 deficit target (3.0% of GDP) has been revised upwards from the 2.9% announced at the start of 2013. This will involve a minimal structural adjustment, which should not impact on activity over the remainder of the year. Budget execution figures indicate that the official forecast of 3.0% of GDP will be achieved in 2013. We forecast that the deficit will fall to 2.5% in 2014. Furthermore, the risks of greater deviations have been eliminated by a VAT increase offsetting the suspension of the tax on first-home ownership. Public debt will hit 132.9% of GDP in 2013, falling slightly to 132.7% in 2014.

Spain: a return to sustained but moderate growth

GDP:-1.3% in 2013 +0.9% in 2014 HICP: +1.5% in 2013 +1.1% in 2014

Latest official figures for 2Q13: the deterioration of the Spanish economy continues to ease, with GDP contracting by 0.1% q/q, an improvement on the -0.4% q/q in 1Q13. This is based on a lower negative contribution from domestic demand (-0.3pp from -0.5pp in 1Q13), resulting from a slowdown in the pace of reduction of the public deficit, and strong export growth (+0.2pp contribution from net exports) beginning to drive investment. This slowing of the deteriorating is also reflected in a slowdown in the rate of contraction in employment. As a result, another decrease in real employee remuneration, coupled with increased labor productivity, pushed down unit labor costs further.

3Q13 forecasts: over the last three months, the Spanish economy has continued to enjoy the positive results of the economic policy decisions taken from 2012 onwards. In particular, the easing of financial tensions has been consolidated, despite new risk factors have appeared. The reduced volatility thus continued to help normalize capital inflows into Spain, the general rise in stock prices and the fall in risk premiums, even more than expected three months ago. All in all, the advance estimate of GDP published by the National Institute of Statistics (INE) indicated that the Spanish economy grew by 0.1% q/q in 3Q13. If this estimate is confirmed, economic growth will have been in line with BBVA Research expectations at the start of the quarter (between 0.0% and 0.1% q/q). The partial economic indicators point to a contraction of domestic demand similar to that observed at the close of the first half of the year (contribution to the fall in GDP of -0.3 pp), that, in any event, is significantly lower than the figure recorded during the second phase of the recession (-0.9 pp on average). Thus economic activity would have once more been supported by net foreign demand, which despite the correction in exports following the upturn in 2Q13, contributed 0.4 pp to quarterly growth. Looking to the fourth quarter of 2013, the information available at the time of writing this report suggests the expansionary tone of the economy will continue, though it will still be anemic compared with previous expansionary phases (MICA-BBVA: between 0.1% and 0.2% q/q).

Outlook for growth in 2013 and 2014: The fundamentals of the Spanish economy suggest it will continue growing over the remainder of 2013, however, in our most likely scenario, this will not be sufficient to avoid a fall in GDP of around 1.3% over the financial year as a whole. In 2014, the economy will grow by 0.9%, given the better outlook for the global economy, the less contractionary nature of fiscal policy and progress with internal adjustments. Although these figures do not represent any significant changes to the forecasts made in August, it is worth pointing out that they do include a slight downward revision of net foreign demand (due to lower anticipated global growth) and an increase in domestic demand (as its components have shown less weakness in 2013). All of this confirms our prognosis for the underlying performance of the Spanish economy: the recession has bottomed out in 2013, paving the way for a classic pattern of recovery in 2014.

Inflation outlook: in 3Q13, headline inflation fell to 0.3% y/y in September and core inflation to 0.8%. This was mainly the result of the end of the base effects generated in mid-2012 arising from the increase in indirect taxes, regulated prices and energy costs. There has also been a downward correction of food prices, which in the case of fresh foods, fell by 4.0% m/m at the close of the quarter. In 4Q13, the October advance CPI indicator points to headline inflation falling (-0.1% y/y), due mainly to expiry of the effect of increased university fees and energy prices a year ago, together with falling food prices. We expect inflation to remain low, at least during the remainder of 2013 and the first half of 2014 as, even though there is considerable uncertainty over imported inflation (commodity prices), there are no noticeable demand pressures on inflation. Therefore, we expect average inflation of around 1.5% in 2013 and 1.1 in 2014.

Public sector: the results observed in the first eight months of the year may be insufficient to ensure compliance with the stability target. Although the consolidation policies are expected to continue, there is a growing likelihood that those that have been announced so far are barely sufficient to offset the negative effects of the economic cycle and the increased cost of servicing the debt. As a result, the deficit at the end of the year would be at the same level as at the end of 2012, around 6.8% of GDP, 0.3 pp above the stability target. Despite this, the resulting fiscal effort for this year is expected to be around 1.7pp of GDP. In 2014, despite not complying with the stability target for 2013, it is expected that both the recovery in the economic cycle and the structural improvement of revenue and public expenditure will cut the public deficit to around 5.8% of GDP, in line with the stability objective.

Box 4. Portugal: After hitting bottom in 2013, with a contraction lower than initially estimated, the economy should begin to grow in 2014

The Portuguese economy continues along the path of adjustment, but it seems to be emerging from the recession earlier than expected. The fall in GDP in 2013 should be somewhat lower than expected, but fiscal consolidation will continue in 2014, and this means the expected recovery will be relatively moderate. Consequently, the country's return to the debt market in mid-2014 cannot be assured.

After the unexpected upturn of 1.1% q/q in activity in 2Q13, mainly fuelled by domestic demand but with foreign demand continuing to support the economy, the latest real and confidence data suggest that in what is left of the year we shall continue to see real data sustaining recovery.

The business and confidence data suggest a stabilization of the economy in 3Q13

The European Commission confidence indicator (ESI) registered an upturn of +3.9pp in its quarterly average in 3Q13 compared with the average for the previous quarter. Although there is no doubt this is a positive figure, it remains at historically low levels (with a standard deviation below the historical average) and suggests more of a stabilization or timid growth than the maintenance of the strong rate of GDP growth observed in the second quarter (1.1% q/q) (Chart 30).

By components, consumer confidence continued to rise in 3Q13, as reflected in the quarter's retail sales, which marked an upturn of +2.1% compare with the average for 2Q13, making three successive quarters of growth (Chart 31). Confidence data for the manufacturing industry also improved, but this improvement was not evident in industrial output for 3Q13, which registered a slight fall of -0.7% in the quarterly average compared with the average for 2Q13 (Chart 32).

Our MICA-BBVA model estimates that the economy will grow slightly in 3Q13 (up 0.2% q/q)

With all the data used by our MICA-BBVA model, the model estimates that GDP might grow +0.2% q/q in 3Q13 (Chart 33), with a slight downward bias, and may even remain flat given the sharp upturn observed in the previous quarter; and, above all, because the real industrial production figure for September was not good enough to maintain the quarterly growth rates registered over the year so far.

The economy should shrink at a slower rate in 2013 than had been estimated in July, and then begin to grow in 2014

Data from the National Accounts for the second quarter and the more recent available data point to improved growth perspectives for the year. Consequently, we have adjusted our forecast for 2013 to -1.6% (from -2.3% estimated in July), in line with the new forecasts presented by the Bank of Portugal (down 1.6% y/y versus a previous estimate of down 2% y/y) and very similar to those presented by the Troika (down 1.8% y/y versus a previous estimate of down 2.3% y/y). In both cases, the revision is based on domestic demand contracting less than initially expected.

We expect the Portuguese economy to report slight growth in 2014 (+0.8%) after three consecutive years of economic contraction. As in previous years, this recovery will be fuelled by domestic demand (+1pp after +1.7pp in 2013), albeit at more moderate rates. The new development, however, will be that for the first time in three years domestic demand will not detract virtually any growth (-0.2pp after 3.3pp in 2013) after having done so at very high rates, -5.3 pp on the annual average in the 2011-2013 period.

2014 budget focused on spending cuts

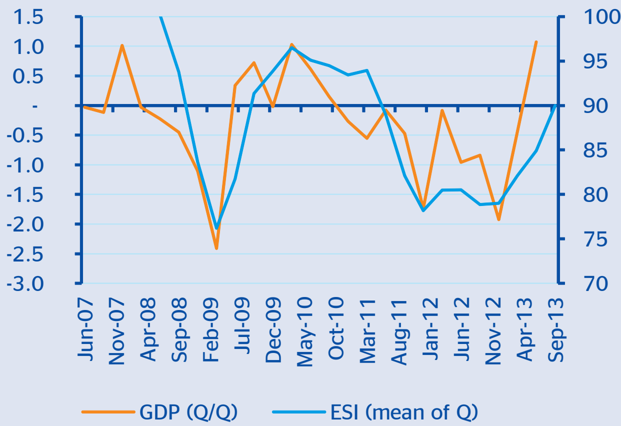
In mid October, the Portuguese government released the draft budget for 2014, forecasting that the target deficit for this year will be met (5.5% of GDP) and that the nominal deficit will be reduced until reaching 4% in 2014. In order to achieve this target, fiscal measures have been presented amounting to EUR 3.9 billion (approximately 2.3% of GDP), EUR 3.2 billion of which (1.9% of GDP) would be spending cuts and the rest measures on the revenue side (EUR 994 million, 0.6%) and one-off measures (EUR 183 million, 0.1%).

Among the main measures for 2014 can be highlighted: i) wage cuts for public employees, with progressive cuts of 2.5%-12% of the salary, which would allow to save EUR 643 million (0.4pp of GDP); ii) the convergence with the Social Security concerning the formula for calculating CGA pensions (being CGA the organization that manages the pension schemes of public sector employees), which implies the reduction of about 10% of the EUR 600-higher pensions and the EUR 419-higer survivor pensions (0.4pp of GDP savings).

The Constitutional Court may rule that some of the measures set out in the budget are unconstitutional. The amount which would be at stake is in the region of EUR 784 million (20% of the total). For these reasons, there might be a deviation of 0.4 pp compared to the 4% target deficit to reach 4.4% of GDP; a level very close to 4.5%, the target initially proposed by the government to the Troika in mid-September, and finally not accepted.

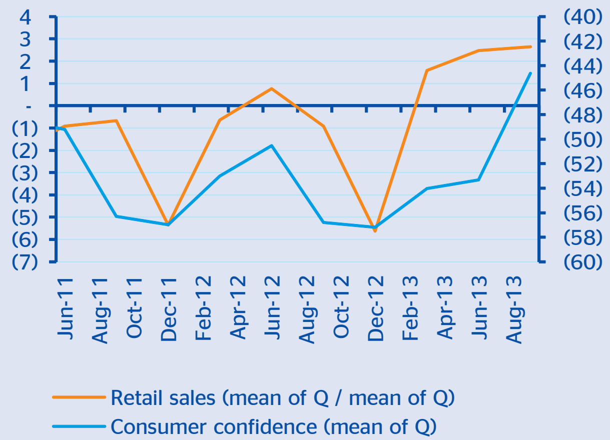
The structural deficit in 2014, estimated with the new growth forecasts, would be at 2.6% of GDP (from 3.7% in 2013). This has been possible thanks to the huge structural deficit reduction accomplished since 2010, nothing less than 5.7% of GDP. Although the structural balance is still high (about half of the reduction achieved between 2010 and 2013), we expect the deficit to remain steady at about 1.4% of GDP in the period between 2015 and 2018.

Chart 30
GDP and ESI



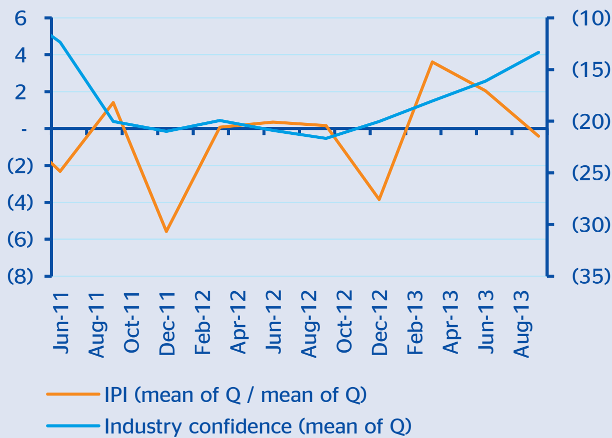
Source: Haver Analytics and BBVA Research

Chart 31
Retail sales and consumer confidence



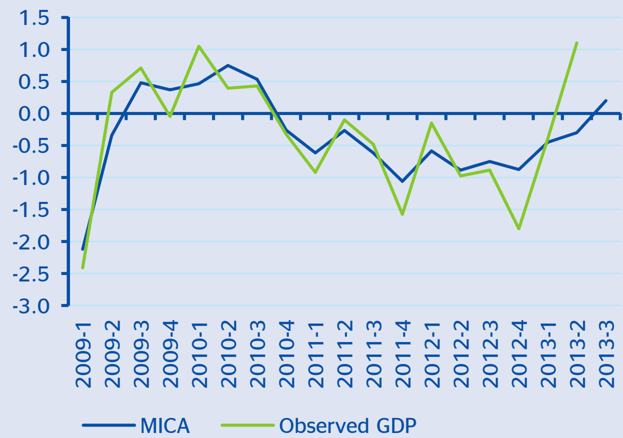
Source: Haver Analytics and BBVA Research

Chart 32
Industrial production index and industrial confidence



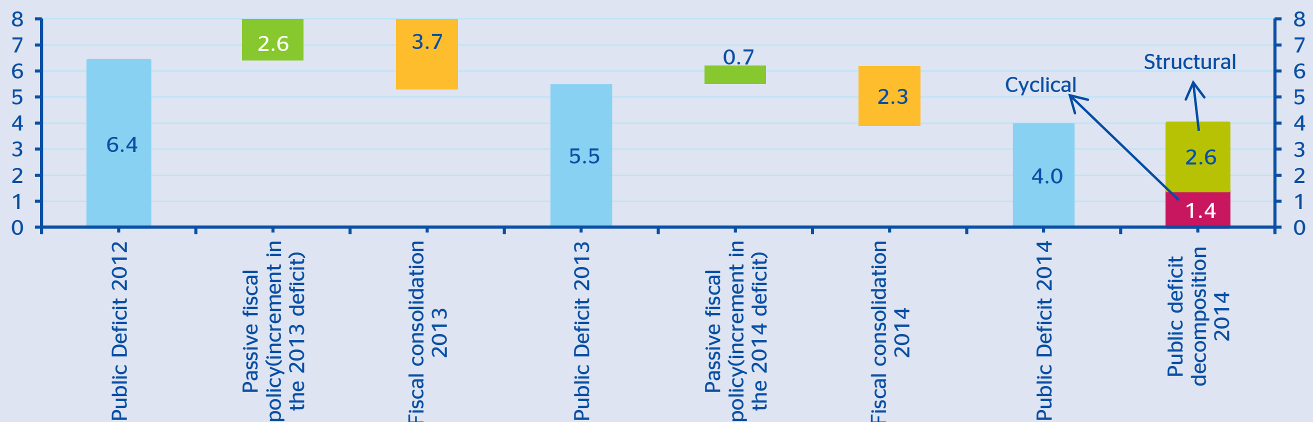
Source: Haver Analytics and BBVA Research

Chart 33
MICA and observed GDP (% q/q)



Source: BBVA Research

Chart 34
Fiscal consolidation (2013-2014) and decomposition of the 2014 fiscal deficit (% of GDP)



Source: BBVA Research and Finance Minister

Box 5. United Kingdom: Economic policy should help to strengthen recovery within the forecast horizon

GDP rose in 2Q13, underpinned by domestic demand and public stimuli ...

GDP increased 0.7% q/q in the second quarter, confirming the solidity of the recovery after the rise of 0.4% q/q in the previous quarter. These data, however, together with the revision of the preceding data, showed a less balanced growth pattern than we were expecting three months ago, with the upturn in activity fuelled by domestic demand (0.7pp), which continued to be shored up by public stimuli under way. On the one hand, the increase in investment for the second successive quarter (0.8% q/q after 0.1%) was underpinned by the sharp growth in public investment (14.1% q/q) and residential investment (2.7% q/q), which continues to benefit from several government subsidy programs (Help to Buy and Funding for Lending Scheme, for example) while investment in the rest of the private sector reported another significant fall (-1.5% t/t), showing more evidence of the limited impact of the FLS on this item. On the other, public consumption continued to fuel recovery, growing by 0.5% q/q, while there was a slight fall in private consumption (0.3% q/q after 0.5%). The buoyant momentum in domestic demand triggered an upturn in imports (2+.9% q/q after falling around 1% in the two previous quarters) and offset the growth in exports (3% q/q), thus leading to a negligible contribution of net exports.

... and the advance GDP data for 3Q13 confirms that the stronger growth is maintained

Growth rose to 0.8% q/q in the third quarter of the year, and continued to show general improvement by sectors. Growth in the services sector continued at a stable and healthy rate of 0.7% q/q. The other sectors also showed relatively strong growth, with GAV in construction rising 2.5% q/q and industrial GAV by 0.5% q/q.

The most recent indicators suggest that solid domestic demand is the main driver of the economy...

Although the GDP breakdown on the demand side is not yet known, the available indicators for 3Q13 suggest that support by domestic demand is maintained (0.6 pp), mainly due to the relative strength of investment and private consumption, while public consumption appears to remain virtually stagnant. However, net exports are likely to have slightly supported recovery (+0.2pp).

On the one hand, the slight improvement in the job market (with employment rising in the region of 1% in 1H13 and the unemployment rate falling by around 0.2pp to 7.7%) together with good economic data have fuelled consumer confidence; and consumption would have been maintained up by the fall in the saving rate. The most recent data also shows increased growth in retail sales up to September, suggesting that private consumption should have continued to grow at a rate similar to the figure registered the previous quarter (0.4% q/q).

Meanwhile, industrial output to August rose again at a rate similar to that registered in 2Q13, which, together with the increase in companies' capacity utilization and better outlook for future demand, should begin to be noticeable in a slight recovery in private investment.

On the foreign sector side, the most recent trade balance data suggests that exports have fallen slightly up to August, while imports would have remained virtually stagnant. However, the significant improvement in foreign orders points towards improvement in retail sales at the end of the year, more in line with our outlook of a further positive contribution of net exports of around 0.2 p.p.

... and the direction taken by economic policy should maintain the rate of growth in domestic spending in coming quarters

On the fiscal policy side, there has 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, and of 1.1% for the following year. The budget implementation data up to September suggests that the government is likely to reach the deficit of 6.5% of GDP estimated by the budget office (OBR), although it is important to bear in mind that the implementation of so many exceptional measures makes it difficult to precisely measure the evolution of public accounts. The most important reason for the reduction in the deficit is the transfer of asset sales of the Bank of England and Royal Mail pensions. This pattern in the public accounts will prompt an increase in public debt of up to around 95% of GDP.

As for the other measures aimed at promoting growth, the most effective one seems to be financial aid for investment in housing - which was again extended in October - 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, although it had already been factored in, was in monetary policy, with a more active role to be played in economic growth and employment after adopting a forward guidance strategy in August. As we anticipated in our previous report, they kept the inflation target unchanged (including three associated clauses which condition the application of this new strategy, and after having previously eased the time period so that growth in prices can return to that target) and monetary policy decisions (including non-standard ones) were tied to the unemployment rate, putting the threshold at 7%. The Bank of England's justification for choosing this intermediate target was to properly reflect the changes in supply, especially the idle capacity of the economy, and also because it is less volatile than other variables and can easily be explained to economic agents. They also stressed the fact that it is a threshold which, if reached, can lead to the direction of monetary policy being reconsidered, but it is not a trigger for changing that policy. In short, monetary policy will continue to be accommodative in the forecast horizon, as we predicted three months ago.

The main factor underpinning the recovery will be the strength of private spending...

Despite the fact that the private consumption fundamentals will not improve significantly within the forecast horizon, improved economic agents' confidence should not trigger an increase in the saving rate on grounds of precaution (as was observed during the 2008 crisis) and will enable households to maintain the rate of spending seen in the first half of 2013. As a result, private consumption may increase over the year to 1.7%. For 2014, private consumption should increase again (1.9%).

This outlook of sustainability in domestic demand, together with public investment plans and the expected consolidation in the Eurozone and in the US should prompt an increase in investment, in a context in which the lending conditions of the sector should gradually be improving. Nevertheless, due to the sharp falls reported at 2012 year end, investment for 2013 as a whole should be down -1.9%, and then report a strong upturn in 2014 (6.8%).

Lastly, public consumption will be neutral, and we expect it to remain virtually stagnant in the second half of the year. Consequently, the average annual growth would be 0.2% in 2013 (after reaching 1.7% in 2012) and will contract in 2014 (-0.4%).

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

The factors which account for the export pattern improved in recent quarters, with imports from the Eurozone and the US playing a more dynamic role, as well as the depreciation of pound sterling (slightly over 5%, after rising by around 6.5% in 2012), and already had an impact through an exports performance that was better than the one we were expecting three months ago. We now expect exports to grow by slightly over 1% this year, practically double the imports, so that external demand will contribute 0.3pp to growth in GDP in 2013 (-0.7pp in 2012). In 2014, greater dynamism of domestic demand will revive imports, so that the contribution from foreign demand will slightly decline to 0.2 pp. Given these developments, our scenario suggests that the current account deficit adjustment will continue, from 3.8% of GDP in 2012 to 2.8% in 2014.

Growth somewhat below the potential, with a slow improvement in the labour market

Considering the factors outlined above, our forecasts include relatively robust and sustained growth in GDP (around 0.5% or 0.6% q/q by quarter), since we are expecting a slight slowing of growth in the final part of the year and next year due to the fact that some stimuli shall disappear: mainly public investment, while financial conditions will remain favourable to sustain private spending. Although our forecast is in line with the cases considered in our previous scenario, we have slightly raised our growth estimate (by around 0.4 pp) to 1.4% in 2013 and 2.3% in 2014 due to the positive surprises observed in the second and third quarters.

Nonetheless, given Bank of England's change of strategy, the evolution of the unemployment rate will be essential to predict at what point the monetary policy committee may consider a change in its policy. Our forecasts still only consider a slow improvement in the labour market over the next few quarters since, after the crisis, job creation will be restricted by the increase in the working day and heavier use of company's installed capacity. All in all, we estimate that the unemployment rate will stand at over 7% until the end of 2015.

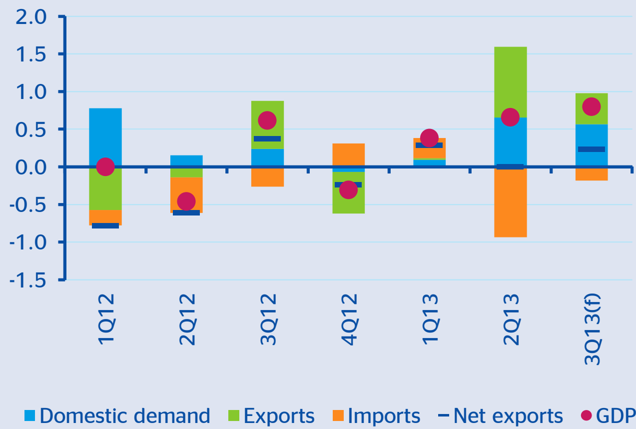
We expect inflation to taper off slowly in 4Q13 and more sharply in mid-2014

After the upturn in inflation in the first part of the year (to 2.9% y/y in June), basically the result of the strong increase in the price of energy products, linked to the depreciation of the pound sterling, core inflation eased off and remained relatively stable at 2.7% y/y in the third quarter. The reason for this pattern was basically the slowing growth in prices in the core component (2.3% y/y from 2.5%), in line with expectations. Therefore, we stand by our forecasts of further slowing in inflation in the last quarter of the year, which should be more intense from mid-2014 on, and then to see out the year around the target inflation figure. All in all, we maintain our forecasts for average annual inflation at 2.7% and 2.2% for 2013 and 2014 respectively.

Against this background, the Bank of England will probably maintain interest rates until the end of 2015

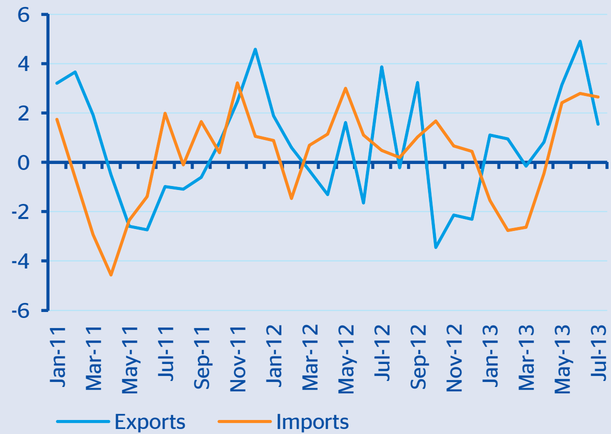
Although our scenario now includes somewhat faster (and equally robust) recovery, with inflation slowing until the target is reached at the end of 2014, considering the Bank of England's new reaction function, we now expect them to maintain the key interest rate at 0.5% until the end of 2015 (instead of until the start of that year), while we believe the likelihood of their extending non-standard monetary policy measures has been reduced further still.

Chart 35
Quarterly GDP growth (% q/q) and contributions (pp)



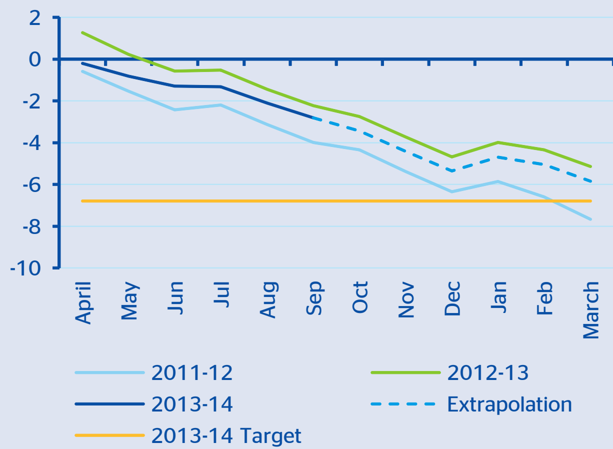
Source: ONS and BBVA Research

Chart 36
Trade balance. Exports and imports (% 3m/3m)



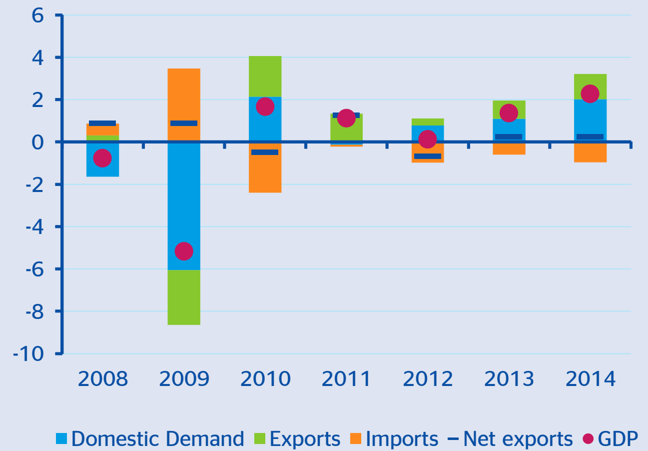
Source: ONS and BBVA Research

Chart 37
Necesidad de financiación del sector público excluyendo intervenciones financieras (% del PIB)



Source: ONS and BBVA Research

Chart 38
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**	**1.6**	**-0.6**	**-0.4**	**1.1**
Private consumption	1.0	0.3	-1.4	-0.5	0.7
Public consumption	0.6	-0.1	-0.5	0.2	0.4
Gross Fixed Capital Formation	-0.6	1.7	-3.8	-3.6	2.2
Inventories (*)	0.6	0.2	-0.5	0.0	0.0
Domestic Demand (*)	**1.2**	**0.7**	**-2.2**	**-1.0**	**0.8**
Exports (goods and services)	11.4	6.7	2.7	1.7	3.9
Imports (goods and services)	9.8	4.6	-0.8	0.4	3.7
External Demand (*)	**0.7**	**0.9**	**1.5**	**0.6**	**0.3**
Prices and Costs					
CPI	1.6	2.7	2.5	1.5	1.4
CPI Core	1.0	1.7	1.8	1.3	1.2
Labour Market					
Employment	-0.5	0.3	-0.7	-0.9	0.1
Unemployment rate (% of labour force)	10.1	10.2	11.4	12.0	12.0
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-6.2	-4.1	-3.7	-2.8	-2.4
Public debt (% GDP)	85.4	87.3	90.6	94.5	95.0
External Sector					
Current Account Balance (% GDP)	0.0	0.1	1.2	2.1	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	1.6	2.3
Eurozone	1.9	1.6	-0.6	-0.4	1.1
Germany	3.9	3.4	0.9	0.6	1.8
France	1.6	2.0	0.0	0.2	1.2
Italy	1.7	0.6	-2.6	-1.9	0.7
Spain	-0.3	0.4	-1.6	-1.3	0.9
UK	1.7	1.1	0.1	1.4	2.3
Latin America *	6.0	4.0	2.5	2.4	3.1
Mexico	5.1	4.0	3.6	1.2	3.1
Brazil	7.5	2.7	0.9	2.6	2.8
EAGLES **	8.4	6.6	5.0	4.8	5.2
Turkey	9.2	8.5	2.2	3.7	3.6
Asia Pacific	8.2	6.0	5.3	5.2	5.3
Japan	4.7	-0.6	2.0	1.9	1.5
China	10.4	9.3	7.7	7.7	7.6
Asia (exc. China)	6.8	3.6	3.7	3.4	3.6
World	5.1	4.0	3.3	2.9	3.6

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: November 4, 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	1.7	2.2
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	1.4	1.5
Spain	1.8	3.2	2.4	1.5	1.1
UK	3.3	4.5	2.8	2.7	2.2
Latin America *	7.6	8.0	7.5	8.8	9.4
Mexico	4.2	3.4	4.1	3.8	3.4
Brazil	5.0	6.6	5.4	6.2	5.9
EAGLES **	5.3	6.0	4.2	4.2	4.3
Turkey	8.6	6.2	8.9	7.5	6.4
Asia Pacific	3.7	4.9	3.1	2.9	3.6
Japan	-0.7	-0.3	0.0	0.1	2.0
China	3.3	5.4	2.6	2.8	3.5
Asia (exc. China)	3.9	4.5	3.4	3.0	3.6
World	3.7	5.1	4.1	3.8	4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: November 4, 2013
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Current Account (% GDP)

	2010	2011	2012	2013	2014
United States	-3.1	-3.0	-3.0	-2.5	-2.8
Eurozone	0.0	0.1	1.2	2.1	2.1
Germany	6.0	5.7	7.0	6.5	5.6
France	-1.6	-2.0	-2.3	-1.6	-1.7
Italy	-3.5	-3.1	-0.7	0.1	0.2
Spain	-4.5	-3.8	-1.1	1.2	1.8
UK	-3.9	-1.6	-4.6	-3.0	-2.8
Latin America *	-0.7	-0.9	-1.6	-2.3	-2.1
Mexico	-0.2	-0.9	-1.2	-1.3	-1.4
Brazil	-2.2	-2.1	-2.4	-3.5	-3.1
EAGLES **	1.6	0.5	0.3	0.1	0.4
Turkey	-6.4	-9.9	-5.9	-6.8	-6.6
Asia Pacific	3.3	1.5	0.9	1.0	1.3
Japan	3.7	2.0	1.0	1.2	1.7
China	4.0	1.9	2.3	2.4	2.8
Asia (exc. China)	2.0	1.3	0.0	0.1	0.4

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: November 4, 2013
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Government Deficit (% GDP)

	2010	2011	2012	2013	2014
United States	-8.9	-8.7	-6.8	-4.0	-3.4
Eurozone	-6.2	-4.1	-3.7	-2.8	-2.4
Germany	-4.1	-0.8	0.2	0.0	0.0
France	-7.1	-5.3	-4.8	-4.1	-3.6
Italy	-4.3	-3.8	-2.8	-3.0	-2.5
Spain *	-9.6	-9.1	-6.8	-6.8	-5.8
UK	-10.2	-7.8	-6.3	-6.0	-5.9
Latin America **	-2.5	-2.3	-2.5	-2.6	-2.6
Mexico	-3.4	-2.6	-3.1	-2.4	-2.3
Brazil	-2.5	-2.6	-2.5	-3.2	-3.7
EAGLES ****	-2.5	-1.9	-2.3	-2.2	-2.0
Turkey	-3.6	-1.4	-2.1	-1.2	-2.1
Asia Pacific	-3.6	-3.7	-3.7	-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	-5.4	-4.8	-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: November 4, 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	2.35	3.25
EMU	1.00	1.00	0.75	1.63	2.06
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	3.2
EMU	2.8	2.6	1.6	1.6	2.1
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.76	0.72	0.78	0.75	0.77
EMU	1.33	1.39	1.29	1.33	1.31
UK	0.65	0.62	0.63	0.64	0.64
Japan	87.8	79.7	79.8	97.3	109.9
China (RMB per USD)	6.77	6.46	6.31	6.19	6.02

Forecast closing date: November 4, 2013
Source: BBVA Research

Table 7
Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	0.7	0.3	1.0	2.3	0.7	1.1	1.4
Public consumption	3.2	3.0	1.3	1.0	1.0	0.9	1.3
Gross Fixed Capital Formation	0.6	-11.6	5.2	7.1	-1.3	-1.0	4.1
Inventories (*)	-0.1	-0.7	0.5	-0.1	-0.6	0.0	0.0
Domestic Demand (*)	**0.9**	**-2.0**	**2.2**	**2.7**	**-0.2**	**0.7**	**1.8**
Export	2.3	-13.0	14.8	8.1	3.8	0.9	4.2
Import	3.0	-7.8	12.3	7.5	1.8	1.2	4.8
Net export (*)	**-0.1**	**-3.0**	**1.7**	**0.7**	**1.1**	**-0.1**	**0.0**
GDP	**0.8**	**-5.1**	**3.9**	**3.4**	**0.9**	**0.6**	**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	0.3	0.9
Public consumption	1.2	2.6	1.8	0.5	1.4	1.5	0.6
Gross Fixed Capital Formation	0.1	-10.4	1.2	3.0	-1.2	-2.1	1.7
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**	**0.1**	**1.1**
Export	-0.6	-11.9	9.0	5.6	2.5	1.2	4.0
Import	0.6	-9.5	8.6	5.3	-0.9	0.6	3.3
Net export (*)	**-0.3**	**-0.5**	**-0.1**	**0.0**	**1.0**	**0.2**	**0.2**
GDP	**-0.2**	**-3.1**	**1.6**	**2.0**	**0.0**	**0.2**	**1.2**
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	-0.3	-4.2	-2.6	0.1
Public consumption	0.6	0.8	-0.4	-1.1	-2.6	-0.8	-0.5
Gross Fixed Capital Formation	-3.8	-11.8	0.5	-1.6	-8.4	-6.0	0.7
Inventories (*)	0.0	-1.1	1.1	-0.1	-0.6	-0.2	0.0
Domestic Demand (*)	**-1.2**	**-4.3**	**2.1**	**-0.8**	**-5.2**	**-3.0**	**0.1**
Export	-2.8	-17.7	11.2	6.9	1.9	-0.2	3.6
Import	-2.9	-13.6	12.3	1.4	-7.5	-4.2	1.8
Net export (*)	**0.0**	**-1.2**	**-0.4**	**1.5**	**2.7**	**1.1**	**0.6**
GDP	**-1.2**	**-5.5**	**1.7**	**0.6**	**-2.6**	**-1.9**	**0.7**
Inflation	**3.5**	**0.8**	**1.6**	**2.9**	**3.3**	**1.4**	**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	-3.3	-5.4	-2.4	-0.3
Public consumption	0.3	4.7	0.1	-5.1	-4.8	-2.2	-1.4
Gross Fixed Capital Formation	-0.3	-8.6	-3.1	-10.5	-14.3	-8.3	2.1
Inventories (*)	0.0	-1.1	0.9	-0.2	0.2	0.0	0.0
Domestic Demand (*)	**0.9**	**-3.6**	**2.0**	**-5.6**	**-7.0**	**-3.3**	**-0.2**
Export	-0.1	-10.9	10.2	6.9	3.2	6.9	5.3
Import	2.3	-10.0	8.0	-5.3	-6.6	2.4	3.0
Net export (*)	**-1.0**	**0.6**	**-0.1**	**4.4**	**3.7**	**1.7**	**1.0**
GDP	**-0.1**	**-2.9**	**1.9**	**-1.2**	**-3.2**	**-1.6**	**0.8**
Inflation	**2.7**	**-0.9**	**1.4**	**3.6**	**2.8**	**0.6**	**0.9**

(*) 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**	**-3.7**	**0.2**	**-1.2**	**-2.8**	**-2.6**	**0.1**
Public consumption	5.9	3.7	1.5	-0.5	-4.8	-1.7	-1.6
Gross Fixed Capital Formation	-4.7	-18.0	-5.5	-5.4	-7.0	-6.4	0.7
Equipment and other products	-2.9	-23.9	4.3	5.3	-3.9	1.0	6.5
Construction	-5.8	-16.6	-9.9	-10.8	-9.7	-11.0	-3.2
Housing	-9.1	-20.4	-11.4	-12.5	-8.7	-9.0	-0.7
Other construction	-1.6	-12.2	-8.4	-9.2	-10.6	-12.6	-5.3
Inventories (*)	0.1	-0.2	0.3	-0.1	0.0	0.0	0.0
Domestic Demand (*)	**-0.5**	**-6.7**	**-0.6**	**-2.1**	**-4.1**	**-3.1**	**-0.1**
Export	-1.0	-10.0	11.7	7.6	2.1	4.6	6.3
Import	-5.2	-17.2	9.3	-0.1	-5.7	-1.0	3.4
Net export (*)	**1.4**	**2.9**	**0.4**	**2.1**	**2.5**	**1.8**	**1.1**
GDP	**0.9**	**-3.8**	**-0.2**	**0.1**	**-1.6**	**-1.3**	**0.9**
Inflation	**4.1**	**-0.3**	**1.8**	**3.2**	**2.4**	**1.5**	**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	1.2	1.7	1.9
Public consumption	2.2	0.6	0.5	0.0	1.7	0.2	-0.4
Gross Fixed Capital Formation	-6.9	-16.7	2.8	-2.4	0.9	-1.9	6.8
Inventories (*)	-0.2	-1.5	1.2	0.4	-0.5	0.3	0.0
Domestic Demand (*)	**-1.6**	**-6.1**	**2.1**	**-0.1**	**0.8**	**1.1**	**2.0**
Export	1.1	-8.7	6.7	4.5	1.0	2.7	3.8
Import	-1.7	-10.7	7.9	0.3	3.1	1.8	2.9
Net export (*)	**0.9**	**0.9**	**-0.5**	**1.2**	**-0.7**	**0.3**	**0.2**
GDP	**-0.8**	**-5.2**	**1.7**	**1.1**	**0.1**	**1.4**	**2.3**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.7**	**2.2**

(*) Contribution to growth
Source: BBVA Research

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.

BBVA | RESEARCH

This report has been produced by the Europe Unit:

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

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

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

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

Francisco José Ortega Castaño
franciscojose.ortega.castano@bbva.com
+34 91 374 75 28

Massimo Trento
massimo.trento@bbva.com

With the contribution of:

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

Tatiana Alonso
tatiana.alonso@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

María Martínez
maria.martinez.alvarez@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

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

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

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

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

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

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

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

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

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

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

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Contact details:

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