RESEARCH

Economic Outlook

Europe

First Quarter 2013
Economic Analysis

- **The reduction of financial stress takes hold in the eurozone** thanks to the ECB's readiness to intervene…
- **… and to the progress towards a banking union**
- **We maintain our growth estimate for 2013 (0.3%),** led by the expected recovery in Germany…
- **… although the periphery will remain in recession in 2013**
- **The risks are still tilted to the downside, but its probability decreases**

Index

Closing date: February 12, 2013

1. Editorial

In the last Europe Economic Outlook in November 2012 we pointed out that the turning point of the crisis was the announcement last summer by the ECB that it was prepared to do whatever it took to defend the euro. Since then, financial markets have continued to improve. If anything, this improvement has been somewhat quicker than expected. The announcement of the OMT bond-purchase programme has been enough to induce a substantial reduction in the spreads on sovereign debt - which was consolidated at the end of 2012- together with a modest return of investment flows in the peripheral countries. In recent months, this trend has been consolidated despite the fact that spreads have recently increased slightly owing to the political rumblings from Italy and Spain.

Various factors have contributed to consolidating this improvement. Outside the eurozone, the risks of adverse external shocks have been reduced by avoiding the fiscal cliff in the US and the somewhat quicker than expected recovery in activity in emerging economies. More important perhaps is the progress made by European authorities with respect to economic policy. On the one hand, the Greek crisis in November was resolved satisfactorily and made it quite clear to the markets that Europe was not prepared to risk its financial stability again by letting Greece leave the Euro. Greece has been allowed to delay its fiscal adjustment for a further two years and it has been given further funding to this effect. However, it is clear that the long-term sustainability of its public debt remains precarious. On the other hand, at the summit of European leaders in December, progress continued to be made towards banking union, with a list of specific measures to implement in 2013 concerning supervision and a single resolution mechanism that did not disappoint. The other leg of European integration (fiscal union) seems to have been postponed for the moment given the political difficulties of moving towards mutualising public debt in an election year in Germany, although it is possible that it will be picked up again in the future. That said, the on-going banking union is a crucial step towards restoring the European funding markets, which are fragmented at the moment.

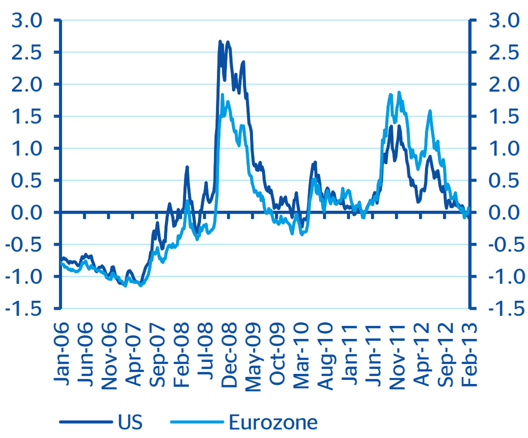
Improvements in these fields have not been transferred yet to economic growth data of real variables and recession in the eurozone continued and even worsened in the fourth quarter of 2012. As we already mentioned in November, this worsening seems to be only temporary and is due more to the delayed effect of doubts that arose in the Autumn and the temporary downturn in global trade rather than entry into a permanent recession. In fact, initial indicators for the Eurozone, in particular Germany, point towards a recovery during the first few months of the year. Obviously, peripheral economies will continue to contract since they are subject to the reduction of public imbalances and to financial conditions that are far from normalised. However, it seems that the core of the eurozone may show moderate growth this year, which leads us to maintain our forecast for GDP growth in the Eurozone as a whole at 0.3%.

The risks around this scenario are tilted to the downside, and are related to several factors. Among them, the failure to meet the fiscal targets, poor management of the crisis in Cyprus or a brake on efforts to progress towards the banking union could revert market conditions. The possibility of an excessive appreciation of the euro could also result in a lower than expected growth.

2. Global economic scenario: Better mood and lower tail risks

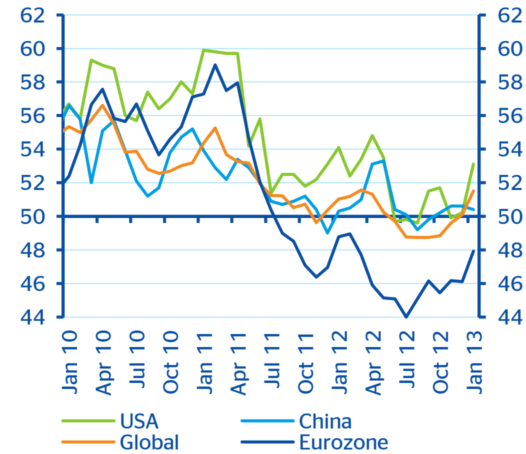
Over the past three months, some threats to the global economic recovery have partly faded, sparking a tide of renewed optimism. Financial markets have seen tensions decrease to two-year lows (Chart 1), particularly in Europe, and almost all assets have benefited from this change in perception. Fading threats to the stability of the global economy have also boosted confidence among consumers and firms. Surging confidence has spread among regions (Chart 2) with a few rare exceptions. However, these market and confidence rebounds have not prompted any significant change in activity yet. According to our global activity indicator (BBVA-GAIN), the slowdown the global economy underwent in much of 2012 came to an end in the fourth quarter of that year. The most recent data have reinforced the perception that the global GDP is accelerating, yet from low levels (below its historical average) and at just a slight brisker pace. According to our estimates, the global GDP in 2012 grew by 3.2%, down from 3.9% in 2011.

Chart 1
BBVA financial stress index



Source: BBVA Research

Chart 2
Confidence indicator (PMI)



Source: Markit and BBVA Rresearch

Economic resilience to uncertainties and advances in the implementation of policies lie behind improved confidence

Data show that China is not heading for a hard landing. Since the third quarter of 2012, the GDP growth has accelerated – as we had been expecting – and the slowdown has come to an end (Chart 3). Investment has accounted for much of the rebound in GDP, on the back of stimulus policies implemented more deftly in 2012 than in 2009. Furthermore, some tentative signs of stronger exports have also emerged, on demand from Asian countries and the US, whereas exports to Europe and Japan have remained a drag. In addition to this, the transfer of political power has been proceeding smoothly.[1]

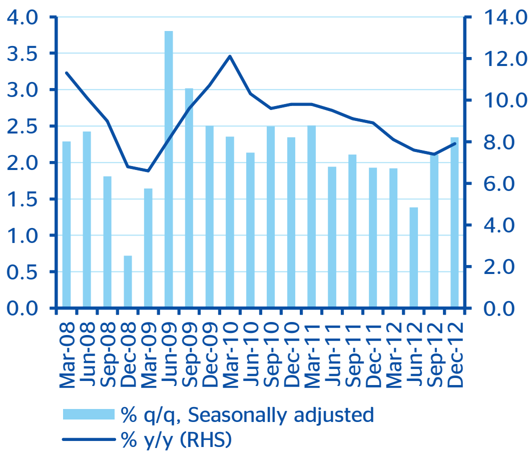
The rebound of the Chinese economy has been hailed in markets as a factor in the global economic resilience and, in particular, in other export-oriented economies and in commodity prices, in particular in Latin America. Although the outlook for China's growth is not as upbeat as in the past, markets seem relieved to have seen the fading of the risk of a severe slowdown.

1: The new leadership team has signaled that it intends to maintain policy continuity with respect to growth-supportive policies and economic reforms. Policy targets as to GDP growth are likely to be 7.5%, the same as in 2012

The US did not fall off the cliff and, in fact, its economy is withstanding uncertainty remarkably well. In spite of a GDP decline in the 4Q12 (-0.1% in annualized terms), the underlying picture is brighter.[2] It had long been argued that consumers and firms withheld their spending, as a reflection of the impact that automatic spending cuts and tax hikes worth some 4% of GDP could have on their finances. However, consumption growth has remained quite stable over the past quarters, averaging a growth rate slightly below the pre-crisis levels. At the same time, the housing sector has undoubtedly gained momentum (chart 4). However, it is difficult to measure the impact of fiscal uncertainty on economic indicators, especially when other policies, such as the monetary policy through the quantitative-easing program, may have succeeded in offsetting (partially) the negative impact of fiscal uncertainty.

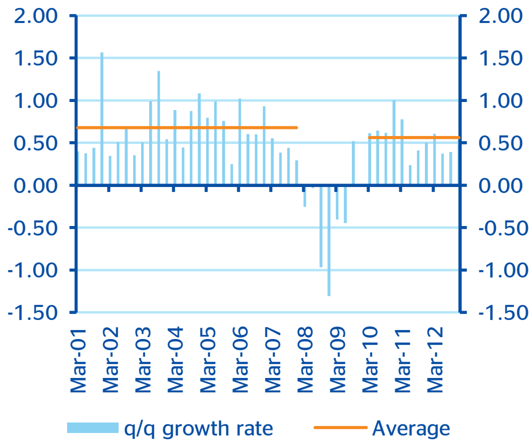
The fiscal deal at the turn of the year that extended most of the 2001/2003/2010 tax cuts and delayed the so-called "expenditure sequester" for two months, among other changes, was welcomed by markets. It avoids a larger drag on the economy and it helps improve the US public-debt sustainability. However, the agreement did not deal with two potential sources of uncertainty. On the one hand, the expenditure sequester is scheduled to take place at the beginning of March. If implemented, there would be an additional drag on the economy of 0.8% of GDP. On the other hand, there was no permanent agreement on the debt ceiling, although a later deal suspended this ceiling until mid-May. Hence, in coming weeks more negotiations will take place to avoid a sharp economic contraction in 2013 and, at the same time, to contribute to fiscal sustainability. However, a grand bargain is unlikely as long as policymakers continue kicking the can and fail to reach a bipartisan compromise to make hard choices.

Chart 3
China: GDP growth



Source: BBVA Research and Haver

Chart 4
US: Consumer expenditure growth (%)



Source: BBVA Research, Haver

Europe did its part: advances in the banking-union process reinforce the commitment to preserve the euro, while the ECB's OMT program seems to be having long-lasting effects as a real backstop, preventing financial tensions from escalating (see Section 3 and Box 2).

The prospects of a sustained global recovery are maintained

The rebound in China's economy, the partial deal on how to tackle the fiscal cliff in the US, and the effects from the ECB's OMT announcement are all good reasons to think that the world economy may have avoided the tail-risk event some market participants were partially pricing in. However, changes in fundamentals are less conclusive. As a consequence, a soft recovery continues being the most likely outlook (Chart 5 and 6), as hard data pointing to a stronger rebound is elusive.

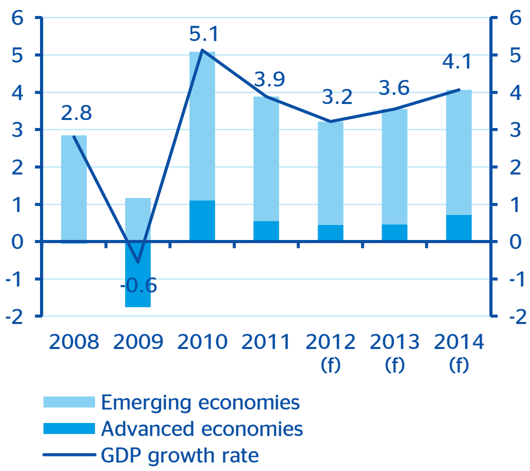
2: The aggregate figure was dragged down by volatile components (private stock building and federal defense spending) along with exports.

On the one hand, even if the US avoided falling off the fiscal cliff, US politicians will still have to agree on some key issues, such as the sequester and the debt ceiling. Either of them could derail the process. Even if agreements are reached, in 2013 the fiscal policy will turn tighter, squeezing household incomes. The real estate sector may be recovering, but the deleveraging process is still a factor at play, and the external sector is far from buoyant. Therefore, we maintain the outlook for the US economy, although we reckon there is scope for potential positive surprises. In 2013 we expect the US economy to grow by 1.8% (down from 2.2% in 2012) and by 2.3% in 2014.

In the eurozone, we roughly maintain our forecast: a rebound of a mere 0.3% in 2013 (after a contraction of 0.5% in 2012), leading to a 1.3% increase in 2014. However, the risks to the whole monetary union remain tilted to the downside, while the decoupling between the core countries and the periphery will persist throughout the forecasting period.

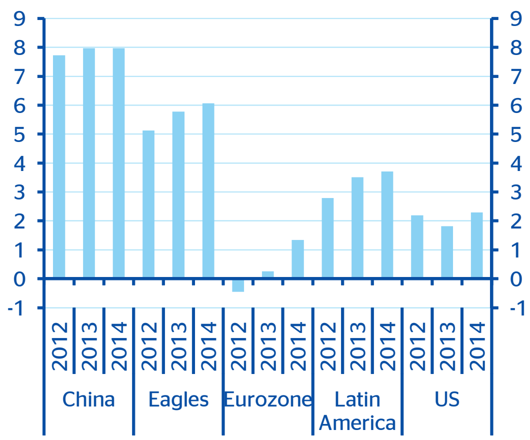
China is arguably the economy where the outlook has become clearer in the short term. The new authorities are committed to sustained growth and that must be interpreted as a clear intention to use loose economic policy. We have revised our projections slightly upwards and now China is likely to grow by 8% in 2013 and 2014. The robustness of China's economy and the resilience of the US economy will play a role in supporting demand in most emerging countries. In Latin America as a whole, we revised our forecasts slightly downwards, due to weaker situations in Brazil and Argentina. In 2013, the Latin American economies will grow by 3.5%, whereas in 2014 they will by 3.7%, approaching to their growth potential. In turn, emerging Asia will show a more robust growth, accelerating its pace to 6.6% in 2013, up from 6.1% in 2012.

Chart 5
World GDP growth rate



Source: BBVA Research

Chart 6
GDP growth rate



Source: BBVA Research

The uncertainty surrounding the global economic outlook looks set to remain high and tilted to the downside, but open to potential upside surprises

In general, most of the global downside risks are, or they are interrelated, with possible events that could occur in Europe (Section 3 and 4), while we can also highlight a few that might occur in other regions.

In US the risk stems from the political disagreement on how to deal with the fiscal deficit. Part of the original fiscal cliff has been avoided, but the remaining two issues – the sequester and the debt ceiling – still lie ahead. On the one hand, the wrangling over these issues may be a source of uncertainty that could hold back consumer spending and investment. On the other, if agreements are not reached, the tightening in fiscal policy could be enough to bring the US economy back to feeble growth rates.

There are still some concerns about the sustainability of China's growth over the medium term. Local debt and the pace of shadow banking lending are probably the biggest financial threats to growth in medium term. Yet even in short term threats could be a constraint for the government in implementing new stimulus measures if needed.

3. Progress made towards the solution of the eurozone crisis

Financial conditions have improved considerably in Europe and fears about the break-up of the Euro seem to be behind us

The last three months have been relatively positive with respect to factors that may help definitively to put an end to the crisis in the Eurozone. On the one hand, the OMT programme announced by the ECB in September seems to be preventing the resurgence of financial tensions even though it has not been used by any Eurozone country. It seems that the mere effect of the announcement of this measure has helped to cap spreads on sovereign debt, since it has made it clear to the markets that if financial tensions surge for one or more countries, it will make the implementation of the programme effective. The OMT programme seems to clarify that markets trust in the ECB's defence of the euro.

The improvement in financial conditions has overcome certain barriers, signalling that the Eurozone is now more resilient. One of these hurdles has been the second Greek crisis, which was resolved in November by means of an agreement under which the Greek government has arranged to take measures to obtain new, less stringent fiscal adjustment targets than the previous ones which also, in principle, make its debt sustainable. There was some uncertainty surrounding the process to reach the agreement but financial tensions in the Eurozone were once again quelled when this uncertainty was resolved.

The third positive aspect is the progress made by the European government towards further integration of banks, which should provide a solid basis to put an end to the fragmented financial flows in the Eurozone in the medium term.

The following paragraphs summarize these two breakthroughs, while Box 1 examines the recent actions of the ECB and the improvement in financial conditions in the Eurozone. Lastly, Box 2 analyzes the recent debate on fiscal multipliers sparked by the International Monetary Fund.

Greece has received a new aid package that will ensure that it remains in the Euro at least in the short term

The Greek elections midway through the year produced a government that was committed to the reforms and fiscal consolidation necessary to ensure Greek permanence in the Eurozone, but they also put a halt to the measures promised by the Troika, which meant that the Greek economy needed additional funding. In addition, a more acute than expected recession in 2012 and the general perception that Greece would not be able to reduce its public deficit to 3% of GDP by 2014 - the figure in the bail-out plan- meant that additional funding was required before the second tranche of the prevailing agreement was paid out.

In November 2012, the new agreement was reached, what means that the deficit target of 3% of GDP must be met in 2016 instead of 2014 as previously expected. The main measures included in the agreement are the repurchase of debt by Greece using funds from the ESM (which will enable it to reduce the debt by 11.5% of GDP), lower interest rates on official loans (2.5% of GDP) and the ECB forfeiting any implicit profit on its Greek debt holdings (4.4% of GDP). The aim of the negotiations was to make Greek public debt sustainable in the long term, which was in principle defined as a debt to GDP ratio of 120% by 2020, although it was ultimately fixed at 124%. Of course, all of the above rests on the assumptions of growth, inflation and public deficit in the base scenario prepared by the Troika. Although the growth assumptions of this scenario are not particularly optimistic, it is subject to considerable risks since the effects of fiscal austerity on growth may be higher than expected and Greece may no longer comply with the other requirements regarding reforms and fiscal consolidation. There also exists a political risk arising from a possible future government that is not committed to the reforms.

The agreement reached in November provides significant support to Greece and its new government, which is committed to approving measures to ensure that the deficit targets are met and, contributes a short and medium-term solution to Greek funding. However, it does not ensure the long-term sustainability of its debt, which requires ongoing commitment to the reforms and an end to the recession (expected by the Troika for 2014) to get into a virtuous circle of growth and debt reduction. Further on down the line it is also possible that a restructuring of the debt in the hands of official creditors (Official Sector Involvement) is considered perhaps after the German elections in September 2013 – something that the IMF complained about – but in the end it was not adopted in the package of measures approved.

The progress towards a banking union has been positive and it will help to restore capital flows back towards the peripheral economies again

A fundamental part of the strategy to end the crisis resides in the European government reforms to supplement the monetary union with a banking and fiscal union that will make it more “coherent”. The EU Summit on 13-14 December disappointed in terms of a fiscal union but it did meet expectations regarding to the banking union was concerned.

During the summit, there was clear political support for the Single Supervisory Mechanism (SSM) and a timetable for the next steps was established even though its effective implementation has been delayed until spring 2014. The ECB will play a key role in the single supervision mechanism, which will affect banks of a significant size and those that were intervened. In terms of the common resolution system for banks in crisis, June 2013 has been established as the deadline for defining the direct recapitalisation criteria for the banking system if necessary by the ESM, while the common resolution mechanism and its funding system (which will be predominantly private) is expected to be approved, in principle, in 2013 although it may be somewhat delayed. No progress was made with respect to the single deposit guarantee fund, which is a medium to long term target.

All this should help to create a single banking system, and to provide security for private investors with regard to the soundness of the resolution mechanisms. Single supervision will also help to break the regulatory fragmentation of the national banking systems, which will help to revitalize the interbank markets.

There is no news on the fiscal union although the EU has relaxed its fiscal objectives for a number of peripheral economies

However, the December summit did not make any reference to any additional advances towards a fiscal union. Until now, the main step taken in this directionhas been the Stability Treaty, which requires signatories to have a structural public deficit of 0.5% of GDP from 2016 onwards. Control of public finances has also been strengthened, with the introduction of the “European semester”, which brings forward Ecofin’s annual budgetary control calendar, and the new macroeconomic surveillance criteria of the “six pack”. However, the debate on mutualisation of national public debt, either through Eurobonds, Eurobills or the debt redemption mechanism proposed by the German institutions, seems to have been put right on the backburner for the moment despite it having been well thought out in the documents drafted by the European Commission prior to the summit. Mutualisation is politically difficult to assume in certain countries in the Eurozone, particularly Germany, and would hand over sovereignty when preparing and controlling national budgets – something that does seem inadmissible in other countries in the Eurozone at the moment. It is possible that the debate is reopened after the German elections in September 2013.

Where there has been a change in attitude from the European authorities in recent months is regarding to the public deficit targets, which have been relaxed for Greece, Portugal and Spain at various points in the last year due to the depth of the recession. European institutions seem to have realised that when the objectives are not met due to cyclical causes, there is no need to take any new additional adjustment measures, and that it is better to define the targets in structural terms rather than relate them to the nominal deficit seems to have been realised by the European institutions. Undoubtedly, part of this attitude is due to the debate launched by the International Monetary Fund on fiscal multipliers which, although still inconclusive (see Box 2), seems to have had some influence in Europe.

Box 1. After the success with the announcement of the bond purchase program (OMT), the ECB faces other challenges: fragmentation of markets, credit recovery and strengthening of the euro

The improvement in the financial credit terms in the Eurozone, which began in summer 2012, following the announcement by ECB of the OMT (Outright Monetary Transactions) programme, continued in the last quarter of 2012 and became more accentuated in the first month of 2013. The mere ECB's announcement has not only avoided further tensions in the market but it has also generated confidence in the Eurozone. Given the lack of negative surprises in Europe, the effect of this announcement has lasted longer than initially expected. This increasingly favourable environment has been facilitated by the decrease in the global risk premium following the end of the risk of a fiscal cliff in the United States. Global indicators of activity have also showed signs of improvement. In a global context of abundant liquidity and reduced risk aversion, the search for profitability has driven investors to adopt certain positions on the risk ladder.

Better market conditions have been seen everywhere, as derived from the following indicators:

1. Decrease in the risk premiums of peripheral countries. This has been particularly striking in the case of countries that have been bailed out (Ireland and Portugal), which have converged rapidly with the risk premiums of countries such as Spain and Italy.
2. Reactivation of issuances by both sovereign and private issuers (financial and non-financial). In the case of sovereign issuers, the attractive yield on Spanish and Italian debt has made it possible to place a high volume of bonds while interest rates have gone down on average to the levels seen one year ago. Equally remarkable is the incipient return to the markets of the countries bailed out (Ireland and Portugal), with their first long-term issues. In general, the appeal of peripheral countries has been evident, with growing demand from foreign investors.
3. As for private issuances, the re-opening of the markets to banks and non-financial corporates on the periphery is also worth mentioning; their stake in total issuances has increased substantially (reaching even 45% of this total in January in the case of peripheral banks).
4. A reversal of capital outflows, in accordance with the balance of payments data. The ECB's announcement stopped capital outflows from peripheral countries and, subsequently, as greater stability consolidated across the markets; new inflows were seen in countries such as Spain.
5. This in turn is reducing the peripheral countries' dependence on the ECB as a source of funding; i.e., the gradual return of flows of private capital is making it possible to partially cover the funding requirements of some of these economies.
6. Consequently, the Eurozone banks, including some entities in peripheral countries, are now ahead in their repayment of the liquidity provided by the ECB in the 3-year auctions held in December 2011 and February 2012. The repayment figures announced in the first few weeks amount to €145 bn, i.e., around 30% of the liquidity allocated in the first of the 3-year auctions, far exceeding analysts' expectations. These figures are a good indicator that banks' liquidity conditions are improving substantially.

As a result of the foregoing, the process of fragmentation of the financial markets in Europe has slowed down, and a gradual improvement has even been seen in recent months. However, this does not mean that markets have returned to normal: there is still a long way to go before they do. The progress made in the process towards a banking union and, in particular, the creation of a single banking supervisor launched after the EU December summit, is a key element in promoting and consolidating this trend.

The ECB has played a critical role in overcoming the moments of greatest strain in Europe and dispelling the most extreme risks. The challenge now is to repair the monetary policy transmission mechanisms and ensure that this improvement in the markets is transferred to the real economy.

Therefore, in the short term there are several factors to keep an eye on:

- Firstly, 3-year LTRO repayment by banks. While repayment was considerable in the first week, largely owing to very favourable market conditions early this year as well as an attempt to use the repayment of funds to the ECB as an indicator that sets the banks apart, as a sign of strength – repayment in the following months will largely depend on market conditions. Accordingly, we expect a more gradual process of repayment in which smaller banks, especially those on the periphery, do not have normal access to the markets.
- Secondly, Euro exchange rates. In the past two months, the euro has seen a strong appreciation against the main currencies. As the ECB itself mentioned in its last monetary policy meeting, this appreciation reflects

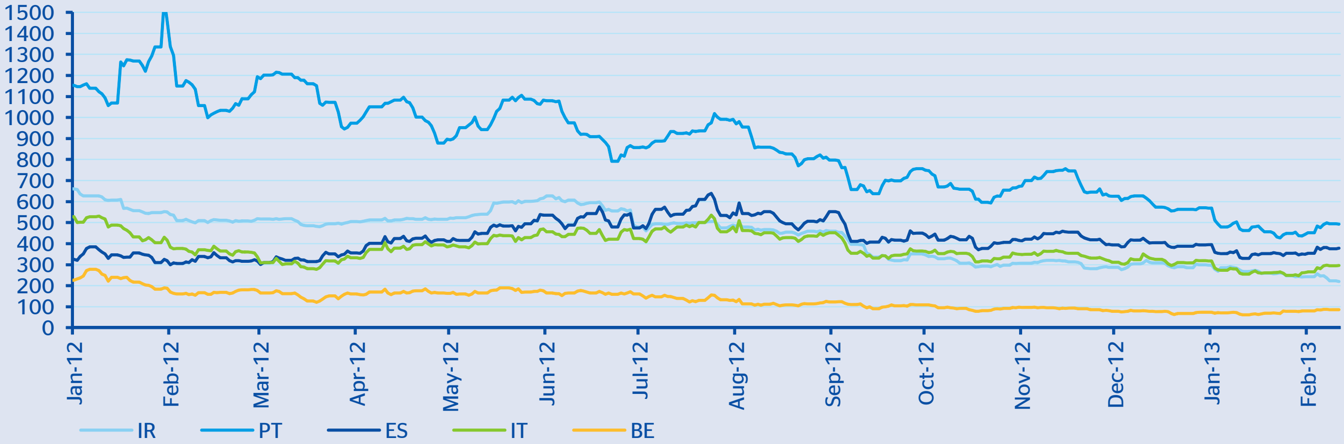
fundamentally increased confidence in the Eurozone, and current levels are not far from the long-term average. However, it is also true that part of the changes observed in certain currencies is a response to the actions of some central banks in developed economies, which have either implemented a number of changes in their monetary policy communication or have even reassessed their monetary policy objectives. Meanwhile, the ECB had maintained a more neutral stance until now although it has now shown signs that this position might change if the euro continues to appreciate.

- Thirdly, the return of the countries bailed out – i.e., Italy and Portugal – to the markets, and the consequences that this might have in relation to the potential activation of the ECB's bond-buying programme (OMT), in this case to facilitate access of these countries to the markets.

We can expect the current trend to carry on in the following months. Still, the risks in the present scenario are for a downward trend and, in the short term, the markets will be sensitive to any negative event.

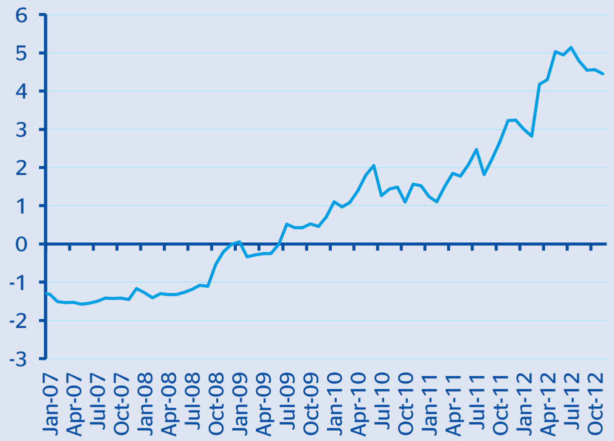
With regard to the ECB's interest rate policy, we still do not expect any changes for the projected period. We consider that the refinancing rate will be pegged at 0.75% during 2013 and much of 2014. The markets and a large number of analysts had in part discounted that there would be an additional decrease in interest rates at the end of 2012, especially after the ECB's meeting in December when forecasts for inflation and particularly growth were subject to a substantial downward revision. However, both markets and a large number of analysts have changed their tact in view of the positive change in the financial conditions since the end of last year and the emergence of confidence indicators which point towards a recovery. Most markets and analysts are no longer considering such a decrease in interest rates.

Chart 7
10y sovereign spread vs. Germany (bps)



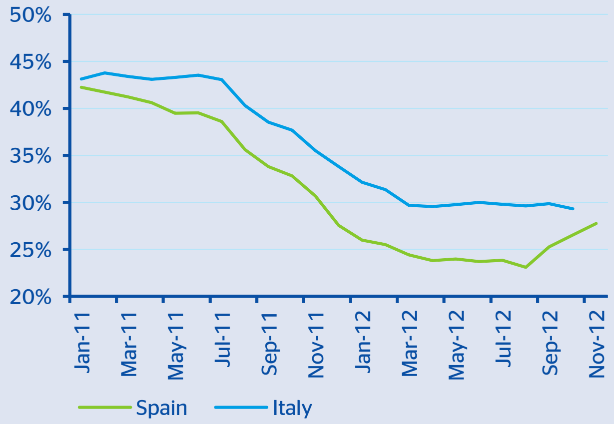
Source: Bloomberg and BBVA Research

Chart 8
Composite measure of Euro Area financial fragmentation*



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

Chart 9
Spanish and Italian public debt held by non-residents* (as % of total debt)



* Ex-ECB. Term investment portfolio
Fuente: Bloomberg y BBVA Research

Box 2. Fiscal adjustments and economic growth in Europe[3]

One of the most controversial topics of the current financial crisis has been the effect of fiscal policy on economic growth. In recent months, this debate has been shaken by the results of the analysis carried out in the World Economic Outlook (October 2012) by the IMF, recently expanded by Blanchard and Leigh (2013). According to these results, the fiscal adjustments could be having a more contractionary effect on GDP than expected.

The stabilizing effects of fiscal policy on production levels are usually measured using a fiscal multiplier, which is defined as the variation of GDP in relation to the discretionary variance of the public deficit (spending, G*, less public income, T*), having removed the cyclical part due to automatic stabilizers:

$$\Delta PIB / (\Delta G^{*}-\Delta T^{*})$$

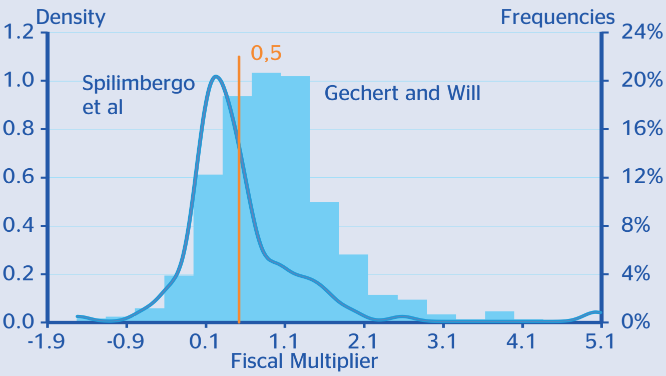
In an interesting article published in the Wall Street Journal in 2009, Robert Barro explained very simply how to interpret the fiscal multiplier. When the multiplier is equal to the unit, if the government purchases an aeroplane or builds a bridge, total economic production increases by the exact amount required to manufacture the aeroplane or build the bridge without reducing the production of other goods. In this way, consumption and investment in the private sector remain unaffected. If the multiplier is higher than the unit, as Barro states "the process is even more marvellous": in addition to increasing production on the aeroplane or bridge, GDP increase even more because of consumption and/or private investment.

Why is it important whether the multiplier is higher or lower for fiscal adjustment? If the multiplier is very high, the negative effects of fiscal austerity on GDP can cause a reduction in income which is more than the ex-ante saving with the adjustment. In this situation, fiscal consolidation could be self-destructive, which is why some economists (e.g. De Long and Summers, 2012) have even defended the increase in public expenditure in order to reduce the deficit.

In practice, empirical evidence provides a variety of fiscal multiplier values, for various reasons. Firstly, because it is difficult to isolate the effects of fiscal stimulation policies from other perturbations that are simultaneously affecting the economy. Secondly, because the fiscal multiplier depends on the composition of fiscal stimulus and the specific characteristics of each economy, in the face of certain situations that vary over time. Examples of these characteristics are the degree of external openness, the exchange rate regime, the response of monetary policy, the stress levels of public accounts, the existence of credit restrictions on the financial system, the level of external borrowing and private sector debt, the percentage of agents that consume only on the basis of their current income, or if the short-term stimulus measures are announced simultaneously with long-term consolidation measures.

As an example of the diversity that exists in fiscal multiplier estimations, Chart 10 indicates the high dispersion of the values that are collected in two literary panoramas. In Chart 10 the line (left axis) represents the density function of the multipliers compiled by Spilimbergo, Symansky and Schindler (2009), which ranges between -1.5 and 5.2, with a mean average of 0.54. Gechert and Will (2012) analysed a wider sample of 89 studies, on which a meta-analysis of 754 fiscal multipliers was carried out, the frequency distribution of which is represented via the bars in Chart 10 (right axis). These authors conclude that the multiplier varies between 2.82 (the maximum impact of military spending, in Neo-Keynesian general balance models when the interest rates reach zero) and -1.3 (the effect of an increase in transfers in a real cyclic model when imports constitute 50% of GDP).

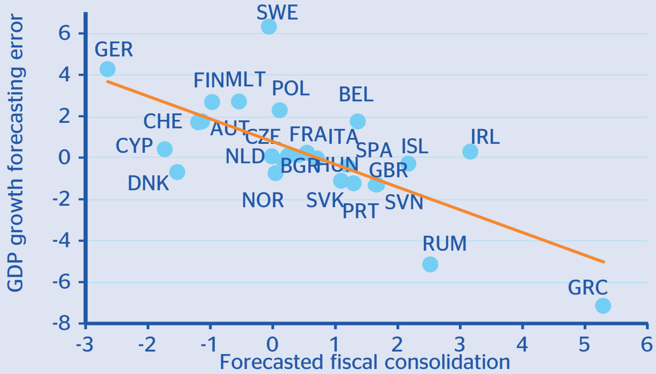
Chart 10
Fiscal multipliers: Density function and distribution of two panoramic frequencies



Source: authors' estimation based on the panoramic of Spilimbergo, Symansky and Schindler (2009) and Gechert and Will (2012)

3: This frame summarises the results of a forthcoming Economic Observatory (Andrés and Doménech, 2013).

Chart 11
Forecasted fiscal consolidation and GDP growth prediction error, 2010-11



Source: Blanchard and Leigh (2013)

Before the crisis a fiscal multiplier of 0.5 was normally accepted as a rule of thumb. This multiplier has normally been used to evaluate fiscal consolidations over the last years (IMF 2010). However, Blanchard and Leigh's results (2013) have questioned this value, upon finding systematic errors in the GDP growth estimates for 2010 and 2011, which were negatively correlated with the fiscal consolidation estimates for those two years.

The evidence is summarised in Chart 11, using a sample of 26 European countries. The horizontal axis represents the fiscal consolidation forecasted in 2010 by the IMF for 2010 and 2011, and the vertical axis represents the forecasting error for GDP growth for these two years. Under the hypothesis of efficient use of the information available, the forecasting error should not be correlated with forecasted fiscal consolidation. However, in Chart 11 the regression coefficient between both variables is -1.095 and is statistically significant (with a t-ratio equal to -4.85).

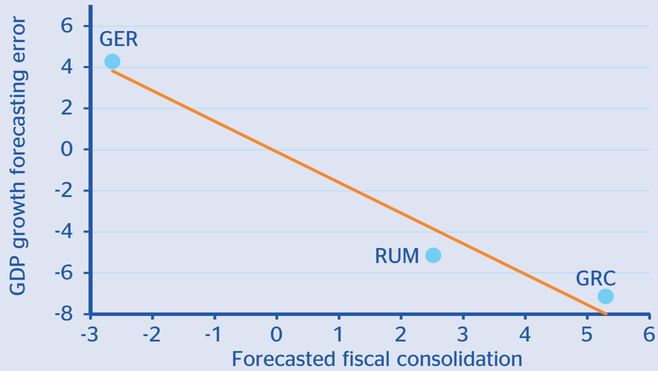
Given that the IMF's GDP estimates take into account the forecasted fiscal adjustments, the conclusion extracted by Blanchard and Leigh is that the multipliers were higher. If on average the multiplier used was 0.5, evidence would suggest that the fiscal multiplier in 2010 and 2011 could have been 1.6 (0.5+1.095).

Although Blanchard and Leigh interpret these results quite cautiously, the reading of their analysis has certainly led a majority to accept that fiscal multipliers are higher than the unit and that the fiscal austerity taken on by some European countries must be queried.

How robust are these results? In response to criticism from Giles (2012 a and b), Blanchard and Leigh carried out different robustness tests, indicating that the results depend on the countries and periods analysed; but the fiscal multiplier is, generally speaking, higher than the unit and is statistically significant when Germany and Greece are excluded.

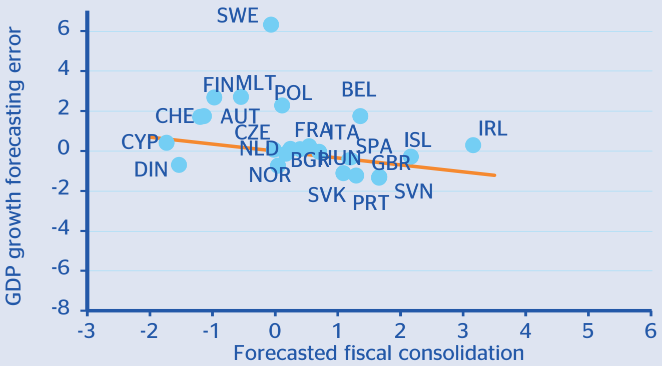
More detailed analysis of the evidence indicated by Chart 11 suggests that Blanchard and Leigh's results were very much influenced by a third country: Romania. Chart 12 analyses the relationship between the forecasted fiscal consolidation and the forecasting error in economic growth for Germany, Greece and Romania, noting a clearly negative relationship (the gradient of the line is equal to -1.49). As for Chart 13, this demonstrates the regression for the remaining 23 countries. In this case the correlation is much smaller and is no longer statistically significant (the regression coefficient falls to -0.347). Therefore, in this sample of 23 European countries, including Spain, it cannot be concluded that the fiscal adjustment has affected growth further than forecasted. The same results are obtained through analysis of the European Commission, the OECD and the Euro Intelligence Unit's forecasts. In other words, the results obtained for Germany, Greece and Romania cannot be generalised for the other countries. It would suggest that in these three concrete cases, it is necessary to carry out more detailed analysis of the reasons for which the forecasting errors were so high.

Chart 12
Forecasted fiscal consolidation and GDP growth prediction error, 2010-11



Source: authors' estimation based on Blanchard and Leigh's data (2013)

Chart 13
Forecasted fiscal consolidation and GDP growth prediction error, 2010-11



Source: authors' estimation based on Blanchard and Leigh's data (2013)

In summary, based on the aforementioned results and reviewing the abundance of existing empirical literature, the following conclusions can be drawn:

- the multiplier depends on the type of fiscal measure: composition is important;
- the multiplier depends on the specific characteristics of each economy;
- although as a general rule a fiscal multiplier between 0.5 and 1 is an acceptable approximation, the different combinations of measures, countries and periods mean that the fiscal multiplier is very wide ranging.

These results indicate that the stabilizing effects of fiscal policies, whether stimulative or adjusting, must be carefully evaluated, with the most detailed cost/benefit analysis possible for each specific case, depending on the economy and time under consideration.

In the same way that at the start of the crisis it was emphasized that the expansive fiscal policies applied should be TTT (Timely, Targeted and Temporary), now the adjustment and fiscal consolidation policies should be TTP: Timely, Targeted and Permanent. Timely because they must be carried out with an appropriate rhythm for them to be effective in reducing the deficit without endangering growth more than necessary, and trustworthy for the financial markets that finance the governments. Targeted because not all public spending (income) has to be reduced (increased) equally, since not all spending policies are equally effective, nor do they have the same effects on growth and on the distribution of their costs between the economic agents. And Permanent because the only way of reducing the structural fiscal deficit is through adjustment policies with permanent effects on public balances.

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4. Outlook for the eurozone

Recession in the EMU intensified in the last quarter of 2012…

The re-emergence of the European turmoil in the second half of last year dragged the activity of the whole of the Eurozone throughout the second quarter; notwithstanding this, the data showed that its negative impact on growth was somewhat lower than anticipated for 3Q12 (-0.1% Q/Q; BBVA Research: -0.3% Q/Q). The data available for 4Q12 suggest that this impact intensified in late 2012, in spite of the lower strains in the financial markets and the reduced uncertainty after the ECB announced its commitment to back the Euro in August and, more especially, the bond-buying programme (OMT) in September.

This delayed impact of the financial variables and of the lower uncertainty on real economy also showed in the decoupling of confidence and real indicators over 2Q12. The deterioration of confidence indicators intensified in 3Q12, while real indicators showed a somewhat more resilient performance of the economic activity. The quantitative data were more in line with national accounting data, revealing a relatively moderate decline in GDP in 3Q12 with a diminished negative contribution of domestic demand (-0.3 pp following -0.6 pp in 2Q12), which was partly offset by a less strong foreign sector (0.3 pp after 0.5 pp in 2Q12). An analysis of the main fundamentals of this evolution[4] indicates that the rising financial tensions did not imply an additional burden on the economy in 3Q12, whereas the ongoing fiscal corrections and the worsening of the key drivers of growth were the main obstacles to the economic activity (Chart 14).

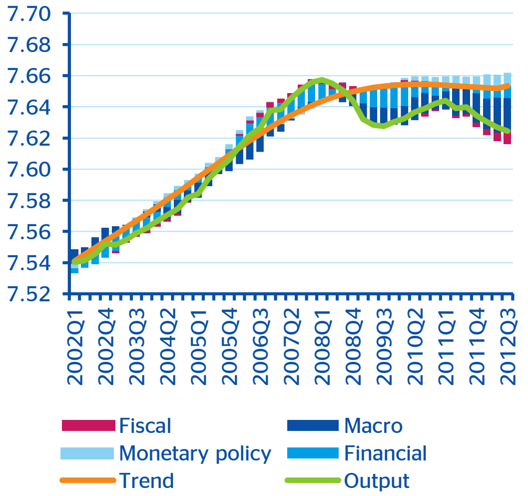
However, the data available for 4Q12 show an opposite performance to that seen in the previous quarter, with confidence indicators improving clearly since November, aided by the improvements in the markets and the lower risk of fracture of the Eurozone, which might suggest that the worst of the recession could have already occurred in 4Q12. Still, real indicators point out to further deterioration of the economic activity.

Taking the information available for 4Q12 into consideration, our MICA-BBVA model[5] estimates a decline in GDP of around 0.2%-0.3% Q/Q in 4Q12, although our macroeconomic scenario envisages a somewhat greater decline, 0.4% Q/Q, which results basically from a poorer performance of real indicators (some of which in December is not yet known). In particular, the slump in retail sales (-1.5% Q/Q), as well as the new deterioration of the labour market and the fall in the disposable income point out to a greater decrease in private spending (-0.4% Q/Q) in the last quarter of 2012. On the other hand, the trade balance data show a decline in exports up to November (-0.8% over 3Q12), partly owed to a certain slowdown in emerging economies and the U.S., which nevertheless was offset by a greater fall in imports (-1.2% over 3Q12). This suggests a weaker positive contribution of net exports (0.1 pp).

The drop in both domestic and foreign demand translated into a strong decline in industrial output (-2.4% Q/Q) and suggest, combined with the excess installed capacity of companies, a new decline in investment (-0.8% Q/Q). Lastly, public finance consolidation will result into a new decline in public consumption (-0.2% Q/Q).

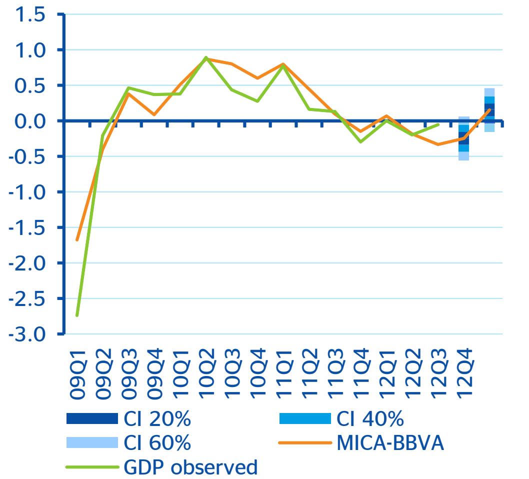
4: For a detailed description of the model, see the working paper "The Euro-Sting revisited: PMI versus ESI to obtain Euro area GDP forecasts", available at http://www.bbvaresearch.com/KETD/fbin/mult/WP_1120_tcm348-260444.pdf?ts=622013.
5: For more information, see box 2 in our report Europe Economic Outlook 3Q 2011, available at http://www.bbvaresearch.com/KETD/fbin/mult/1108_Europeeconomicoutlook_i_tcm348-265250.pdf?ts=622013.

Chart 14
Eurozone: Output, trend and shocks



Source: BBVA Research

Chart 15
EMU: MICA-BBVA and GDP observed (% Q/Q)



Source: Eurostat and BBVA Research

… broadly in all of its Member States

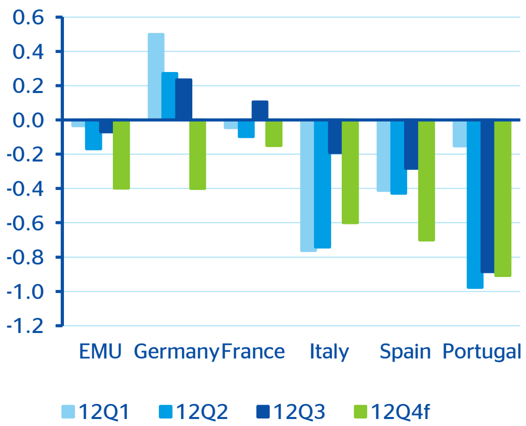
Our models estimate that also production in central European countries may have declined in 4Q12, with German GDP falling by -0.4% Q/Q (0.2% in 3Q) and French GDP falling by -0.2% Q/Q (0.1% in 3Q). In addition, the recession may have accelerated in Italy (-0.6 Q/Q following -0.2% in 3Q) and Spain (-0.7% Q/Q following -0.3% in 3Q), whereas the pace of deterioration of the economy may have remained unchanged in Portugal (-0.9% Q/Q) (Chart 16).

Signs of recovery in sight – though still unclear

Although there is only very limited information for 1Q13 (only confidence data from agents in January are available), signs of slight recovery can already be discerned in the beginning of the year. In particular, confidence indicators surprisingly rose again in January for the third consecutive month, spurred by the good evolution of the German economy and mainly as a result of Germany's strong domestic demand. Additionally, while the detailed results of 4Q12 are still not known, the most recent data point out to a less negative reading of the decline expected for that quarter. The lower volume of exports in the last part of 2012 may have been temporary as a consequence of the slowing economy seen in some countries, mainly China and the U.S., although our forecasts still suggest robust global growth for this year, even somewhat better than anticipated three months ago.

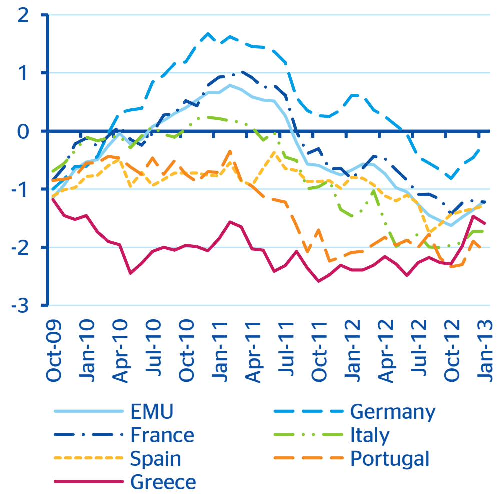
With still very limited information, our MICA-BBVA model estimates a growth of around 0.2% Q/Q as early as in the first quarter of 2013, in line with our macroeconomic scenario, which is somewhat more optimistic than the official forecasts of international institutions and the rest of analysts. Notwithstanding this, the divergence among countries will increase, as these indicators suggest that the decline of the German economy in 4Q12 should be temporary in the light of its robust fundamentals of growth. In contrast, the outlook is more pessimistic in the case of France and, especially, for the rest of countries, where the deterioration of the pillars of domestic demand and the negative impact of the adjustments of economic imbalances indicate that recession will continue over much of 2013.

Chart 16
GDP growth (q/q) by countries



Source: Eurostat and BBVA Research

Chart 17
EC economic sentiment (standardized)



Source: European Commission and BBVA Research

The efficacy of the ECB's announcement was greater than expected, translating into a greater decline in financial tensions

Compared with the assumptions in our forecasts of three months ago, the biggest surprise was the greater decrease in financial tensions at the end of last year after the ECB announced that it was ready to buy debt in September. This improvement was also favoured by the satisfactory solution of the Greek crisis, which made it clear that Europe as a whole was not willing to let Greece fall, thus renewing its commitment to the euro project. According to our models, the impact of this greater reduction in financial tensions might translate into higher growth for 2013 (+ 0.3 pp) rather than 2012 (+ 0.1 pp), which might offset the negative impact of the stronger decline in the economy now expected for late 2012 (with an effect of -0.1 pp on the average growth in 2012 and -0.2 pp in 2013), as well as greater strengthening of the Euro, mainly in the short term (-0.1 pp).

Regarding the rest of the main factors that determine short- and medium-term growth, there has been no significant change since our last publication. On the one hand, the processes of fiscal consolidation are progressing in line with expectations, with most countries meeting the objectives set for 2012, while the measures announced for 2013 had already been envisaged in our previous scenario and should be, in principle, sufficient to attain the objectives for this year as well. Still, failure to comply with them in any of the countries of the periphery cannot be ruled out. However, the European authorities might eventually be somewhat more flexible if the recession lingers. On the other hand, the drop in oil prices has been a little greater than expected, although its impact on the economic activity will be very limited and will translate mainly into further deceleration of inflation over 2013 (-0.1 pp to -0.2 pp). Lastly, in the light of the data on inflation and activity, we do not expect any change in the monetary policy of the ECB, which will maintain interest rates until the end of the projection period. At the same time, the ECB might still be ready to take exceptional measures, if needed, to restore the good operation of the financials system (see Box 1).

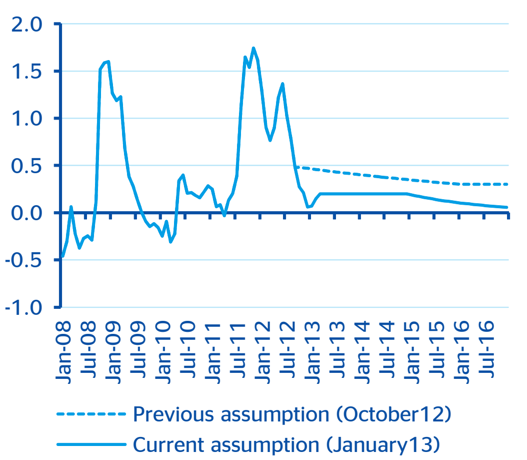
In view of all of the above, we maintain our growth estimates for both 2012 and 2013. Still, we should stress that this scenario depends critically on how the turmoil of the Eurozone is managed in the following months. In particular, we are assuming that the European authorities will use the window of opportunity opened with the ECB's announcement to continue taking appropriate steps towards a banking union and, later, a fiscal union. Also, we expect the confirmation and consolidation of some of the progress made in the past three months, such as access to funding from banking markets and a number of bailed-out countries (Ireland and Portugal), and the dissipation of the doubts over the sustainability of public debt in Greece after the agreement reached in late 2012 (debt repurchase, lower interest rates and profits of the ECB). On the other hand, Member States, especially those in the periphery, will carry on with their process of fiscal consolidation and correction of both domestic and external imbalances. In light of all this, the forecasts in our scenario are that financial tensions and the lower uncertainty on the survival of the Eurozone should remain at the current levels, with some ups and lows, over the entire projection period.

After the mild recession of 2012, the economy will virtually stagnate in 2013 and grow slightly below the potential in 2014

For the entire 2012, we maintain our estimation of a -0.5% drop in GDP, as the positive impact of the smaller fall of the economic activity in 3Q12 as well as the greater easing of financial tensions will fully offset the further deterioration of the activity in the last quarter of the year. For 2013, the ongoing decrease in financial tensions and the lower uncertainty on the continuity of the Eurozone should be enough to offset the poorer evolution of the other growth factors, as well as the carry-over effect of the decline in GDP in 4Q12. In consequence, we maintain our projection that GDP will grow by a meagre 0.3% for the whole of the year. However, the likelihood of a recession for next year is still high, at around 35%.

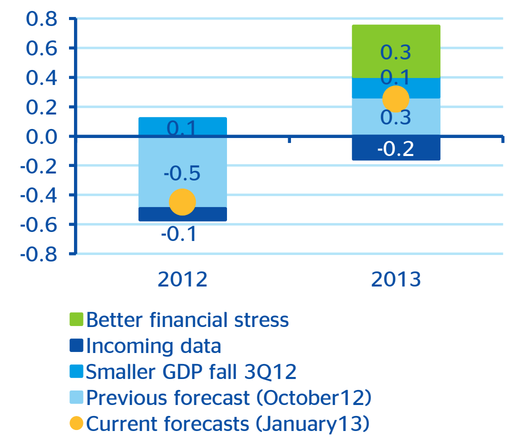
For the first time, we are disclosing growth estimates for the year 2014, which show consolidated recovery to attain a growth rate of 1.3%, slightly below the potential.

Chart 18
EMU: Financial stress index



Source: BBVA Research

Chart 19
EMU: Annual GDP growth and drivers



Source: BBVA Research

Domestic demand will carry on draining growth, although lower funding costs in the periphery and improved confidence should mitigate its decline

The reduction in the economic activity in the whole of 2012 was determined by the evolution of the components of domestic demand. Private spending may have declined significantly (-1.2%), dragged by the fall in the disposable income that households have been experiencing from the start of the crisis (-1.2 pp in the first three quarters of 2012), as a result of both pay restraints and higher taxes and inflation.

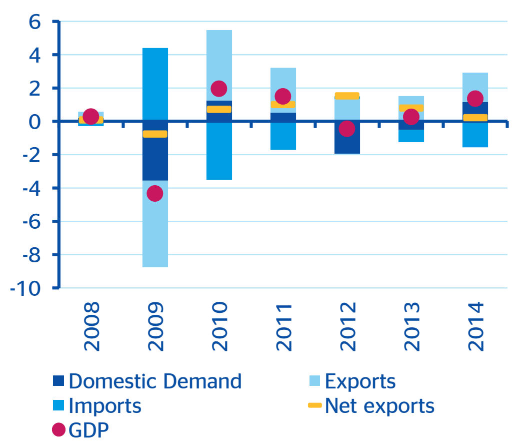
The slight economic recovery envisaged for the first part of the year will underpin an improvement in households and businesses' confidence, and should be enough to stabilise the labour market over 2013. In spite of all this, the fundamentals of households' consumption will still be very weak, while the process of household deleveraging will continue, especially in the periphery, resulting in a standstill of private spending this year (-0.3%).

The intense weakness of private demand, combined with a slowdown in exports, will eventually translate into a strong drop in investment in 2012 (-3.8%), basically as a consequence of a slump in expenditure in capital assets and transport, while the decreased investment in construction was linked mainly to public expenditure cuts. Additionally, the strong deterioration in the expected future demand might have materialised into a significant reduction in inventory stock, draining around 0.5 pp from GDP growth. For 2013, we estimate a new fall in investment, although to a lesser extent (-1.3%), as businesses' installed capacity should be enough to meet the still weak expected demand, both domestic and external, while the still restrictive funding conditions will also put a brake on investment decisions.

Owing to the need to ensure the stability of public finances, the little room for manoeuvre in fiscal policy will eventually impose a clearly pro-cyclical evolution on public consumption. Our economic scenario envisages a slight decrease in public expenditure in 2012 (-0.2%), although it will intensify in 2013 (-0.5%). As a result, public deficit in the whole of the Eurozone will diminish by 1,1pp in 2012 and 0.7pp in 2013 to 3% and 2.3% of GDP respectively, with an increase in public debt of up to 89.6% of GDP in 2012 and 90.3% in 2013.

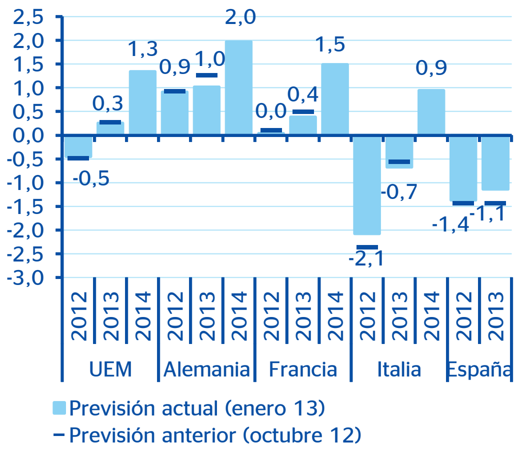
For 2014 we expect a widespread improvement in the evolution of all the components of domestic demand. Both the improvement of the labour market and the consolidation of recovery should underpin a growth in private spending of around 1%, while investment will rebound (3.3%) to face the greater expected demand. Lastly, we estimate that, once public balances have been improved, public consumption will not be a burden on the economy.

Chart 20
EMU: Annual contribution to growth (pp)



Source: Eurostat and BBVA Research

Chart 21
EMU: Growth forecasts by country



Source: BBVA Research

Net exports will cushion the fall in economic activity in the following quarters, although their positive effect will gradually vanish

In 2012, in spite of the slowdown in exports (3.1% from 6.5% in 2011), they were the only source of growth in the whole of the Eurozone. This, together with the slight drop in imports (-0.4%), materialised into a strong positive contribution of net exports (1.5 pp) to GDP, partially offsetting the negative impact of domestic demand (-2 pp). For 2013, exports will continue benefiting from the sustained growth of the global economy, which will nevertheless be somewhat smaller this year (3.6%). As a consequence of this, as well as the strengthening of the Euro, we do not expect any further increase in exports (3.3%). In addition, our estimations point out to a certain recovery of imports, which will result in a reduced contribution of the foreign sector down to 0.8 pp, enough to offset in full the less heavy burden of domestic demand (-0.5%). For 2014, this gradual disappearance of the external support will continue (0.2 pp) owing to the resurgence of imports due to the recovery of all the components of domestic demand (Chart 20).

The labour market will not improve until 2014

In view of this scenario, our forecasts are that the labour market may continue deteriorating slightly in the following quarters, although showing signs of stabilisation already during 2013 . As a result, we expect a moderation in job destruction this year (-0.4% after 0.7% in 2012) that will translate into a 0.4 pp increase in the unemployment rate up to 11.8%. For 2014, the consolidation of recovery, with the economy growing slightly below the potential, our forecasts estimate new job creation (0.4%), which will make it possible to reduce the unemployment rate to 11.4%.

The core of the Eurozone will slow down, while the periphery will remain in recession in 2013 to grow timidly in 2014

The deepening of the European crisis in mid-2012 translated into a negative impact on the economic activity that was widespread across the Eurozone, although there are clear differences among the countries. For the whole of 2012, the final data on the national accounts will probably show that the growth of the economies of northern and central Europe slowed down significantly, with Germany still seeing positive growth (0.9% from 3.1% in 2011) and the French economy becoming stagnant (1.7% in 2011), whereas there were significant declines in GDP in the countries of the periphery (with a 2.1% fall in Italy, -1.4% in Spain and -3% in Portugal). (Chart 21 and table Eurozone member states: detailed analysis).

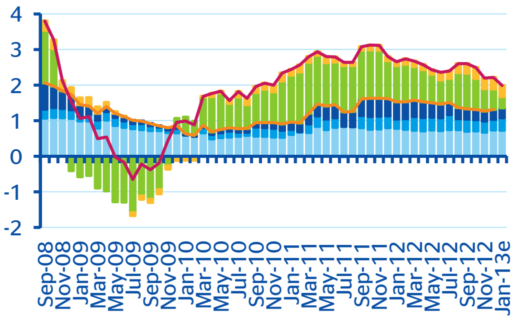
In addition, the incipient recovery envisaged for the whole of the Eurozone in 2013 will not be general. Even if institutional issues are gradually solved at the European level, the peripheral countries will need to keep correcting their accumulated economic imbalances and facing a fragmentation of the financial markets that results into still very high funding costs . For this reason, our forecasts envisage a certain consolidation of the recovery, though a slow one, in the countries of central and northern Europe (Germany: 1%, and France: 0.4%), while the countries of the periphery will remain in recession (Italy: -0.7%, Spain: -1.1%, and Portugal: -1.2%). In sum, our scenario does not envisage a widespread return to growth in all Member States until 2014, and there will still be clear differences among them, with central European countries growing above the average of the Eurozone (1.3%), while growth will be more moderate in the peripheral countries (Chart 21).

Inflation will already be below the objective of the ECB in the first quarter of 2013, and will remain at this level over the entire forecasting horizon

Inflation slowed by 0.2 pp down to 2.3% a/a in the last quarter of 2012, a little more than expected (-0.1 pp), basically owing to greater moderation in the increase of the price of energy products, after remaining steady at 2.5% a/a in 3Q12. With regard to core inflation, it performed as expected, slowing by 0.1 pp down to 1.6% a/a. As a result, the annual average inflation for the whole of the year decelerated by 0.2 pp down to 2.5%, while core inflation increased by 0.1 pp up to 1.8%.

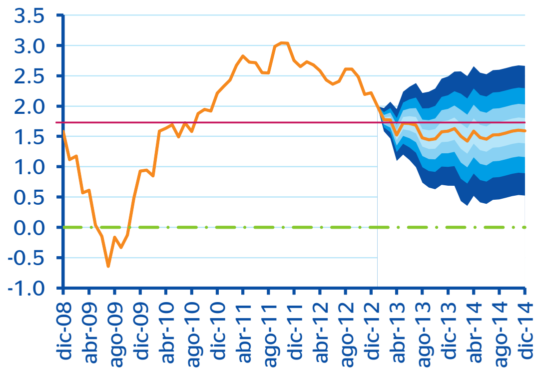
The data put forward for January showed that inflation decreased again, in line with our scenario, to 2% a/a. For the coming months, our forecasts are that inflation will carry on decelerating until April as a consequence of the base effect of lower energy prices, to subsequently fluctuate around 1.6% over the rest of the year. The weakness of domestic demand will feel also in a decrease, albeit slower and more moderate, in core inflation. For 2013, we now expect that the annual average inflation will slow down to 1.6%, whereas core inflation will decelerate to a lesser extent down to 1.5%. For 2014, inflation should remain relatively steady in view of the absence of inflationary pressure on the side of demand. However, in the last weeks the upside risks have slightly increased as a result of rising oil prices and the recent appreciation of the euro.

Chart 22
EMU:
Inflation (% y/y) and contributions by component



Source: Eurostat and BBVA Research

Chart 23
UEM: Inflación (% a/a)



Source: Eurostat and BBVA Research

The risks over economic activity continue tilted to the downside: noncompliance with the fiscal targets, financial stress linked to Greece or Cyprus, euro appreciation

Although the measures taken during the second half of the last year reduced the risk of rupture of the euro and, therefore, the probability of a severe recession scenario in the monetary union, our forecast remains tilted to the downside.

On the one hand, there are risks that financial stress may arise again for several reasons. First, the periphery of Europe may not meet its fiscal targets. Some of the fiscal consolidation process carried out so far has been based on one-off measures (privatization, asset transfers, etc.) that have not permanently reduced the structural deficit. If, in response to the failure to meet its objectives, governments will implement more austerity, the crisis could intensify, although this risk has a low probability because the European Commission has made clear that it will not impose additional adjustments if deviations from the objectives respond to cyclical deterioration. In turn, despite the agreement to reduce public debt in Greece late last year, it does not dispel the doubts about the Greek debt sustainability in the medium and long term.

In addition, we continue to see implementation risks of the agreements reached at the European level, as the possible activation of the support program of the ECB if it is not satisfied the conditions assumed or for any disagreements between central and peripheral countries. Also, these risks could result from a possible delay in important issues concerning the banking union.

Table 1

Eurozone Budget Monitor

Germany

		2010	2011	2012	2013	Comments
Government Deficit Target	% of GDP	-4.1	-0.8	-0.5	-0.5	1.
BBVA Forecast				0.1	-0.1	
Interest payment		-2.5	-2.5	-2.3	-2.2	2.
Cyclical		-0.8	0.1	-0.2	-0.5	
Cyclically adjusted excl. Interests		-0.8	1.7	2.7	2.7	
Structural adjustment			2.5	1.0	0.0	
General Government Debt		82.5	80.5	83.3	81.2	3.
Central budget execution (y.t.d.)	bn €	-36.6	2.5	until Dec-12		4.
	% of GDP	-1.4	0.1			

1. According to provisional data, the government closed 2012 with a surplus of 0.1% of the GDP, compared to a deficit target of 0.5% of the GDP. For 2013, we estimate a slight deficit (-0.1% of the GDP) below the fixed target (-0.5% of the GDP), primarily due to an increase in expenditure as it is an electoral year and because of the slight surplus obtained in 2012.

2. The 2013 consolidation strategy consists of maintaining government expenditure at constant levels and using extra tax revenue to reduce the deficit.

3. Provisional data for 2012 highlights that the total amount of new federal government debt has reached €22,500 million, which is lower than initially estimated for 2012 (€28,100 million). Thus meeting the targets four years ahead, marked by the so-called "debt brake", with respect to the EU fiscal agreement for Germany.

4. Federal expenditure in 2012 reached €306.8 billion, which is below the estimated amount of €311.6 billion. Whereas in terms of revenues, the amount of €256.1 billion was very close to the initially estimated amount of €256.2 billion. This positive result is attributable to the well-performing labour market and particularly the fiscal consolidation implemented by all levels of government.

France

		2010	2011	2012	2013	Comments
Government Deficit Target	% of GDP	-7.1	-5.2	-4.5	-3.0	1.
BBVA Forecast				-4.5	-3.2	
Interest payment		-2.4	-2.6	-2.6	-2.7	2.
Cyclical		-1.1	-0.8	-1.2	-1.6	
Cyclically adjusted excl. Interests		-3.6	-1.8	-0.7	1.0	
Structural adjustment			1.8	1.1	1.7	
General Government Debt		82.3	86.0	90.7	92.7	3.
Central budget execution (y.t.d.)	bn €	-92.7	-91.2	until Dec-12		4.
	% of GDP	-4.6	-4.5			

1- We still estimate that the government will meet the deficit target of 4.5% of the GDP for 2012. Nevertheless, we forecast that the 2013 deficit will be slightly above the 3% target.

2- The measures for 2013 amount to €30,000 million (1.5% of the GDP) two thirds of which are derived from higher taxes (distributed equally between households and corporates). It is expected that the impact on growth is minimised due to diversification in the increase between the different tax brackets.

3- We estimated that the public debt, as a percentage of the GDP, reached 89% at the end of 2012. For 2013, we predict that this debt will continue growing, but only by some 2pp more this time.

4- The 2012 deficit was slightly less than for 2011, some €2 billion less (0.2% of the GDP), the final data will be published in March.

Continued on next page

Table 1
Eurozone Budget monitor

Italy

		2010	2011	2012	2013	
Government Deficit Target	% of GDP	-4.3	-3.8	-2.6	-1.7	1.
BBVA Forecast				-2.8	-2.0	
Interest payment		-4.5	-4.8	-5.4	-5.9	2.
Cyclical		-0.6	-0.5	-0.9	-1.2	
Cyclically adjusted excl. Interests		0.8	1.6	3.5	5.1	
Structural adjustment			0.8	1.9	1.6	
General Government Debt		119.2	120.7	127.7	132.6	3.
Central budget execution (y.t.d.)	bn €	-60.9	-43.4	until Dec-12		4.
	% of GDP	-3.9	-2.8			

Comments

1- The public deficit reached 2.8% of the GDP in 2012, slightly above the revised target of 2.6%. We estimate that the 2013 deficit will, once again, be higher than the marked target (-1.7% of the GDP) reaching -2% of the GDP, whereas a high level of uncertainty remains due to the possible impact of the elections.

2- The measures presented in the 2013 budget include, in terms of revenues, the 1pp VAT increase as of July. In terms of expenditure: greater control will be exercised on the health budget; there will be a freeze on civil servant recruitment during 2013-14; no property or vehicles will be acquired; there will be a limit on consultancies and a reduction in the number of local and regional authorities as well as cuts in funding for political parties.

3- The debt as a percentage of the GDP, increased by 7pp from 120.7% in 2011 to 127.7% in 2012. For 2013, we estimate that this ratio will continue to increase by possibly another 4.9%.

4- The surplus normally obtained during December was some €8500 million more this year than for 2011. Nevertheless, sales of SACE and SIMEST (€1700 million) are not accounted for in order to reduce the deficit according to the Maastricht criteria. Even so, the increase is still significant regardless of this sale (€6800 million). This surplus is mainly attributable to the second property tax bracket, which is paid in December each year.

Spain

		2010	2011	2012	2013	
Government Deficit Target	% of GDP	-9.7	-8.9	-6.3	-4.5	1.
BBVA Forecast				-7.2	-5.9	
Interest payment		-1.9	-2.5	-2.9	-3.6	2.
Cyclical		-1.1	-1.9	-3.8	-4.7	
Cyclically adjusted excl. Interests		-6.6	-4.6	-0.5	2.3	
Structural adjustment			2.0	4.1	2.8	
General Government Debt*		61.5	69.3	87.2	93.7	3.
Central budget execution (y.t.d.)	bn €	-37.6	-46.0	until Nov-12		4.
	% of GDP	-3.5	-4.4			

* Excluding aid to the financial sector

1- The latest available data (3Q12) highlights a high probability that the target established for 2012 (6.3% of the GDP) will not be met. Again, we predict that the target established (4.5% of the GDP) will not be met for 2013, with a rounded deficit of 5.9% of the GDP

2- No other measures have been presented for 2013. The government has committed to creating an independent fiscal agency in the first quarter of 2013, based on European Commission recommendations. This reform is crucial if Spain is to stand with better institutional efficiency and transparency that allow it to continue regaining confidence in terms of the country's public finances

3. We still estimate that the public debt will be above 85% in 2012 -excluding assistance given to the financial sector-, as well as debt forecasts for 2013 (93.7% of the GDP)

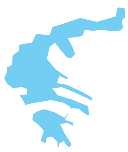
4. Data for the last government budget execution shows that the accumulated deficit grew slightly in November, 2012 to 4.4% of the GDP, which is 2pp below the year-end target.

Continued on next page

Table 1
Eurozone Budget monitor

Greece

		2010	2011	2012	2013	Comments
Government Deficit Target	% of GDP	-10.6	-9.0	-7.3	-4.5	1.
BBVA Forecast				-6.6	-4.5	
Interest payment		-5.9	-7.2	-7.2	-6.5	2.
Cyclical		-0.6	-2.4	-3.6	-4.3	
Cyclically adjusted excl. Interests		-4.3	0.1	4.1	6.3	
Structural adjustment			4.4	4.1	2.2	
General Government Debt*		148.3	170.6	157.5	168.4	3.
Central budget execution (y.t.d.)	bn €	-21.1	-12.9	until Dec-12		4.
	% of GDP	-10.1	-6.6			



1. The government deficit and public administrations for 2012 is 6.6% of the GDP, thus hitting the 2012 target agreed with troika. For 2013, we expect to reach the deficit target of 4.5% of GDP.

2. The 2013 budget estimates some extra savings of €9400 million, derived mainly from salary reductions and pensions as part of the €13.5 billion of the 2013-14 austerity plan.

3. As a consequence of the reduction in interest rates applied in the first bailout (2010) and the extension given to credit expiry periods of the second bailout (2012), together with the debt buyback operation of €31.9 million. (with an average discount of 66.2%), the 2012 public debt is lower compared to the previous year (reaching 157.5% of the GDP). The achievement of this buyback program has allowed part of the IMF assistance to be released (€44,000 million).

4.- Government debt and Public Administrations have reduced considerably between January and December, 2012; up to €-12.9 million (-6.6% of the GDP) from €-19.7 million recorded in 2011(-9.4% of the GDP); thus meeting the 2012 targets.

Portugal

		2010	2011	2012	2013	Comments
Government Deficit Target	% of GDP	-7.3	-5.9	-5.0	-4.5	1.
BBVA Forecast				-5.0	-4.5	
Interest payment		-2.9	-4.0	-4.5	-4.9	2.
Cyclical		-0.5	-0.9	-1.6	-1.8	
Cyclically adjusted excl. Interests		-6.5	0.5	1.2	2.2	
Structural adjustment			3.5	3.7	2.7	
General Government Debt		93.5	108.0	118.9	122.0	3.
Central budget execution (y.t.d.)	bn €	-4.6	-8.3	until Dec-12		4.
	% of GDP	-2.7	-5.0			

1. The fiscal effort carried out during 2012 (approximately 3.7% of the GDP) was enough to hit the deficit target of 5% agreed with the troika. Nevertheless, confirmation regarding the inclusion of airport concession revenue is still pending (€800 million; approximately 0.5% of the GDP). For 2013, the target of 4.5% of the GDP will be achieved with the fiscal effort forecasted by the government (3.2% of the GDP). Primarily, the temporary measures applied in 2012 must be compensated this year (approximately 1.7% of GDP), the unravelling of the cyclical deficit (0.2% of the GDP), reduction of the deficit target (0.5% of the GDP) and a higher estimated interest payment (0.4% of the GDP).

2. The fiscal effort for 2013 is mainly based on the forecasted fiscal revenue increase of 2.6% of the GDP and an expenditure reduction of 0.6% of the GDP. The main measures that support this year's fiscal consolidation effort include the increase in the average income tax rate, from 9.8% to 11.8%; 13.2% if we add the bracket reduction and the extraordinary rate of 4% for higher incomes, with this measure the expected increase in revenue is approximately €2810 million (1.7% of the GDP); and in terms of expenditure, the reduction of pension payments (from 3.5% to 10% for pensions greater than €1350), which is aimed at reducing expenditure by €420.7 million (0.3% of the GDP).

3. In January this year, the treasury has allocated €2500 million at 3, 12 and 18 months at lower interest rates than those obtained in the last bids. For the shortest period, 3 months, €300 million has been allocated at an interest rate of 0.667% instead of 1.936% paid previously; at 12 months some €1200 million were allocated at an interest rate of 1.609% instead of 2.101% from the previous bid; and at 18 months, €1000 million could be allocated at an average interest rate of 1.963%, lower than the 2.99% paid previously.

4. The 2012 public deficit reached €8320 million, which is lower than the amount agreed with the troika (€9028 million). Revenues from the privatisation of Aeropuertos de Portugal (ANA) helped achieve this result. The 2012 public deficit represents 5% of the GDP. Portugal's primary balance reached a positive figure of €517.4 million, whereas a deficit of €89.2 million was expected.

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

Eurozone member states: detailed analysis

Germany: The solid domestic base will again drive the economy from the start of 2013, although it will continue to be sluggish because of the uncertainty in Europe

GDP:+0.9% in 2012 +1.0% in 2013 +2.0% in 2014 HICP: +2.1% in 2012 +1.7% in 2013 +1.6% in 2014

Latest official data for 3Q12: The economy slowed down again due to the strong slow-down in exports, while imports showed themselves to be rather more resistant by continuing to be held up by private consumption, which was gaining a hold throughout the year (also supported by good progress in the labour market). However, investment remained very weak. Unlike in many other member states, public consumption was another support for growth.

Estimates for 4Q12 and 2012: The indicators available point to the fact that the economy would have contracted significantly at the end of 2012 (- 0.4% q/q), possibly as a result of further deterioration of exports, dragged down by the drop in activity in the other member states and also by the slowdown in the US and some emerging economies. In particular, the data on the trade balance showed a noticeable decline in exports (- 2.1% up to November), which together with the decline in orders from overseas meant a considerable drop in demand and in industrial output (- 2.7% q/q). This should again have had a negative effect on investment. The serious deterioration of consumer confidence is likely to be reflected in a reduced private consumption, in line with the decline seen in retail sales (- 1.1% q/q). All of the foregoing supposes that the GDP would have grown 0.9% in 2012, maintained mainly by net exports (0,9pp), while although both private and public consumption put up some resistance, the contribution from domestic demand was something of a drain on growth (- 0.3pp) thanks to drop in investment and the reduction of inventories.

Prospects for 2013 and 2014: The continued improvement in the labour market, though somewhat moderate as regards the creation of jobs on the horizon (increase in hours and not in people after the previous adjustment, which was the reverse), means there will be no noticeable increase in wages and therefore in the household disposable income in a context of a moderation of inflation. As a result, and together with the improvement in consumer confidence, there should be an upturn in private consumption in 2013 and 2014. Meanwhile, the streamlining of the public balances will allow a neutral fiscal policy to be pursued with a view to consolidating the recovery. So this increase in domestic demand will be reinforced by a robust world-wide growth that will continue supporting exports, so that in order to satisfy the increase in both internal and external demand, there will need to be increased investment, especially significant in 2014. All this will result in a growth of GDP in 2013 of around 1%, which will accelerate throughout 2014 (2%), with a growth based more on domestic expenditure, which will start reducing the strong current account surplus of the German economy.

Prospect of inflation: Inflation will decelerate slightly throughout 2013, after staying relatively steady at around 2% throughout the second semester of 2012, and is forecast to be slightly below 2%. However, inflation will remain slightly above the average for countries in the Eurozone, thanks to the strength of domestic demand. Both this year and next, there will be pressure for inflation to rise as a result of wage increases, although up 'till now there is no evidence that these are materializing, with core inflation at low levels (below 1.5% throughout 2Q12).

Public sector: According to provisional data, the government has closed 2012 with a surplus of +0.1% of GDP for the first time since 2007, compared with the target deficit of -0.5% of GDP. Compared with the previous year, the central government considerably reduced its deficit, while local governments and especially social security funds have achieved a considerable surplus, as they had already done in 2011. This good performance of the public balances chiefly reflects the good performance of the income sustained by the strength of domestic demand and the continued improvement in the labour market. For 2013, we estimate a slight deficit (- 0.1% of GDP), to the extent that public expenditure will continue to support growth, which will also be affected by the elections to be held this year. .

France: The vulnerability of the domestic demand will show weak growth in 2013, and will not show any clear signs of recovery until 2014

GDP:+0.0% in 2012 +0.4% in 2013 1.2% in 2014 HICP: +2.2% in 2012 +1.5% in 2013 +1.5% in 2014

Latest official data for 3Q12: GDP grew slightly by 0.1% q/q in 3Q12, confirming the stagnation of the economy during the first three quarters of 2012. This growth was maintained by consumption, both private and public, but it was compensated for by the decline in the investment. With respect to the overseas sector, the growth in exports was accelerated for the second consecutive quarter, although they remain weak, while imports were reduced (dragged down by the decline of investments and intermediate goods), which resulted in a positive contribution from net exports 0.3pp.

Estimates for 4Q12 and 2012: Data available for 4Q12 point to production contracting at the end of the year (- 0.2% q/q), although possibly in a more moderate way than in the rest of the Eurozone (- 0.4% q/q), showing once again the relative strength of the French economy during the European crisis. Bearing this information in mind, we maintain our forecast of a stagnation of the economy in 2012, although with a slight change to the composition and revealing rather more worrisome signs facing the performance of the economy on the forecast horizon. Moreover, private consumption stagnated for the second consecutive year, while investment slowed down because of worse expectations for future demand. However, in spite of the slow-down in exports, imports had practically stagnated, so that the positive contribution from foreign demand would have avoided a greater decline in activity. In fact, only public consumption would have continued growing at a decent rate, although to the extent that this support has faded away faced with the need to reduce the public deficit, doubts will increase about the sustainability of the recovery in the short term.

Prospects for 2013 and 2014: The continued deterioration of the labour market over the last year, together with the possible exhaustion of support from the public sector will result in a clear reduction of internal expenditure, which together with the reduction of corporate profits and the reduced degree of openness of the French economy will be noticed in the weakness of investment. Domestic demand will therefore remain practically stationary in 2013 (+0.2pp), while support for the robust growth of the global economy will only be noticed in a slightly positive contribution from net exports (+0,2pp). So, it will not be until 2014 when the economy picks up again (1.5%), maintained by the growth pattern that is typical of this economy: a jump in domestic demand (1.4pp), with practically no contribution from the overseas sector (0.1pp).

Inflation outlook: Inflation slowed down considerably in 4Q12 to stand at 1.5% y/y in December, clearly below the average inflation for the rest of the Eurozone. The foregoing is a result not only of the decline in demand but also the reduced dependency on energy by the French economy. Given the weakness of the expenditure of homes across the whole forecast horizon, as well as the absence of pressure on the supply side because of the deteriorating labour market, our forecasts show that inflation should remain relatively stable at these levels (1.5%) in both 2013 and 2014.

Public sector: The preliminary data on budget performance for 2012 point to the fact that the government would have reached its target deficit of 4.5% of GDP this year. However, it is reckoned that the public debt will have been increased to as much as 89% of GDP. The government's target for 2013 is to reduce the deficit to 3% of GDP, although our forecasts consider a somewhat larger deficit due to the fact that the macroeconomic projections of the budget are rather more optimistic than ours (0.8% as opposed to 0.4% growth of GDP of BBVA Research). The fiscal adjustment for this year amount to 30,000 million Euros (1.5% of GDP), two thirds of which come from tax increases (shared out fairly between households and corporates).

Italy: The recession will relax during the first half of 2013. Moderate growth in 2014

GDP:-2.1% in 2012 -0.7% in 2013 +0.9% in 2014 HICP: +3.3% in 2012 +2.0% in 2013 +1.7% in 2014

Latest official data for 3Q12: Although the contraction of GDP was moderated significantly (- 0.2% q/q after -0.7% q/q in 2Q12), surprisingly rising, the composition of growth continued showing how fragile the economy was, with all the components of domestic demand contracting strongly, maintained only by net exports thanks to the collapse of imports.

Estimates for 4Q12 and 2012: Information available for 4Q12 suggests that the recession would have intensified (- 0.6% q/q) at the end of 2012, again weighed down by the major deterioration of domestic demand. In particular, the decline in retail sales together with reduced consumer confidence indicates that there is still a considerable rate of deterioration of households' consumption. This reduced demand was reflected in the strong reduction in industrial output (- 2.1% up to November), which should have continued having an effect on investment decisions. Only net exports should have cushioned the decline in activity, although it is likely that exports also ended up suffering from the worsening situation in the other member states. These forecasts for 4Q12 suppose that GDP would have contracted -2.1% in 2012, 0.3pp less than anticipated three months ago by the surprising rise in 3Q12, determined by the strong contraction of domestic demand (- 4.9pp) which was compensated for only partially by a slight growth of exports and the collapse of imports, resulting in a positive contribution from the overseas sector (2.8pp). Throughout 2012, therefore, there was a continued adjustment of the accumulated economic imbalances because of the crisis, with the trade deficit being reduced by more than 1.5pp to 1.6% of GDP, while the public deficit would already have been below 3% of GDP.

Perspective for 2013 and 2014: For 2013, GDP will again contract -0.7% for the year overall, although the recession will be cushioned during the first semester to show a mild recovery from then on. The growth factors continue to be very weak and will continue to slow down growth. In particular, the rate of unemployment could increase rather more in the next quarters, while inflation continues above 2% good part of the year, which will be reflected again in a decline in private consumption. With these expectations on demand and the uncertainty about the impact of fiscal consolidation, our forecasts include a new decline in investment, although at a smaller rate. With respect to the support from net exports, we hope that this will reduce throughout the year, due in particular to the reduced decline in imports. The recovery should be consolidated in 2014, although we anticipate a moderate growth of around 1%, since no really strong measures have yet been taken to end the problems of low potential growth of the Italian economy.

Inflation outlook: Inflation moderated significantly in 4Q12, at around 0.8pp up to 2.6% in December, as a result of the disappearance of the base effect of the rise in IVA in September of 2011. For this year, we expect that inflation will continue to reduce throughout the year, but will continue to remain clearly above the average for the Eurozone, among other things because of the rise in VAT announced for the middle of the year and in spite of the strong decline expected in domestic demand.

Public sector: The public deficit in 2012 would have reached 2.8% of GDP, slightly above the revised target of 2.6%. For 2013, we estimate that the deficit will again be rather over the target set (- 1.7% of GDP) at -2% of GDP, while uncertainty remains high because of the unknown factors of the new government's fiscal policy. The measures presented in the 2013 budget include, on the income side, the increase in VAT by 1pp as of July. On the expenditure side, there will be greater control in the health budget, freezing the hiring of civil servants in 2013-14 and not acquiring any properties or vehicles, and also computer enquiries and the acquisition of material will be limited.

Spain: The recession will bottom out in 2013 and give way to moderate growth in 2014[6]

GDP:-1.4% in 2012	-1.1% in 2013	+1.1% in 2014	HICP: +2.4% in 2012	+2.0% in 2013	+1.1% in 2014

Latest official data for 3Q12: The economy contracted by -0.3% q/q, a similar rate of deterioration seen in the first semester of the year and less than forecast in the spring. On the demand side, the basic features of the composition of growth remained: both private consumption and investment fell again, although at a smaller rate, while the contraction of public consumption intensified. This was reflected in a rather less negative contribution from domestic demand (-1,1pp). In spite of the solid state of exports, the upturn of imports supposed that the contribution from net exports fell slightly (0.8pp).

Estimates for 4Q12 and 2012: The still preliminary data published by the National Institute of Statistic indicate that the Spanish economy should have contracted in 4Q12 rather less than was anticipated at the start of the quarter (- 0.7% q/q compared to -0.9% q/q), which would place the decline for 2012 as a whole at around -1.4% y/y. The partial indicators of conjuncture available confirm an accelerated contraction of domestic demand in 4Q12 (- 1.6pp), caused by the fiscal measures implemented, while foreign demand would have continued being the main driving force of the economy (0,9pp). Although it is temporary, the acceleration of the recession was also reflected in an increase in unemployment of 1pp to 26% at the end of the year.

Prospects for 2013 and 2014: The first data available for 1Q13 point to the activity continuing to contract, but at a lower rate that the one recorded at the end of 2012 (MICA-BBVA: up to -0.2 or -0.3% q/q). There is expected to be a contraction in GDP of around -1.1% in 2013 For 2014, the practical conclusion of some of the internal processes of adjustment and the reduced pressure that the fiscal policy is expected to have (which will help domestic demand to stop having a negative effect on growth), together with the consolidation of exports as a support for growth will bring about an increase of GDP of 1.1%. However, there will continue to be risks of a fall given the fact that this forecast is subject to consolidation of the improvement in confidence in the European economy, particularly in the Spanish one. Throughout 2013, the rate of unemployment will surpass 26%. However, in 2014 it is hoped that the rate of unemployment will fall, especially during second half of the year.

Inflation outlook: Consumer prices were surprisingly down in Q4, at an average general inflation for 2012 of 2.4% and the core inflation 1.6%. As long as there are no inflationary pressures of demand, it is expected that this moderation in the growth of prices continues in 2013 and 2014 (+2.0% and +1.1%, respectively).

Public sector: The public deficit was reduced in 2012 in spite of the cyclical deterioration of the economy. However, the data available (up to 3Q12) do not indicate the fact that this reduction was modest, which is why there is an increased likelihood of not reaching the target for the deficit, set at 6.3% of GDP. The accumulated deficit of the public administrations increased 1.5pp throughout Q3, to stand at the -5.2% of GDP. It is expected that the fiscal adjustment has intensified during 4Q12, but the year will probably close with a deficit of around 7.2% of GDP. Moreover, this deviation also reduces the likelihood of meeting the targets both in 2013 and in 2014. According to our forecasts, in the absence of any additional measures, the 2013 deficit would be around 5.9% of GDP (1.5pp over the target), and this deviation would drag on until 2014. Nevertheless, the public structural balance (i.e. once the effect of the economic cycle has been discounted), would be around the target of 0% of GDP already in 2014, accumulating almost 7pp of correction in only three years.

6: For more information, see the magazine SpainWatch for the first trimester of 2013 available at: http://www.bbvaresearch.com/KETD/ketd/esp/nav/geograficas/espana/historico/publicaciones/observatorios/observatoriosecon/index.jsp

Box 3. Portugal: Economic contraction in 2012 slightly sharper than expected

Available data for the fourth quarter suggest a 3% contraction of the Portuguese economy for 2012

As in most of the countries of the Eurozone, the activity has contracted more than forecasted at the end of the year. Our short term model (MICA-BBVA) suggests that GDP fell by 0.9% q/q in 4Q 12; that is, an approximated contraction of 3% for 2012, slightly deeper than anticipated three months ago (-2.8%). The negative data of retail sales (-6.3% q/q in Q4) and the slowdown of the labour market (with the unemployment rate increasing approx. 0.3pp in 4Q to 16.5% in December) suggest that the domestic demand may have held back significantly the economy in the last quarter of 2012. On the other hand, the growth of the exports has slowed.

The outlook for 2013 worsens slightly, with the international trade sector as the main growth support

During the current year the Portuguese economy will continue in recession, although at a lower rate than in 2012. The main recessive factors will be the continuation of fiscal adjustment and the recurring high financial tensions, which will push downwards the domestic demand and will be again only partly compensated by the growth of the exports, which should recover driven by a greater growth in Germany and the strong demand outside Europe.

In this way, we estimate that the 2013 GDP will contract by 1.2% y/y (versus a prior forecasted contraction of 0.7% y/y). The revision is basically due to a higher decline in the private consumption and, to a lower extent, in the public consumption (many of the fiscal consolidation measures were included in our forecast of three months ago). The internal demand will continue holding back the economy in 2013 (-2.5 pp), although at a more moderated pace compared to our estimates for 2012 (-6.9 pp). The international trade sector will continue softening the decline through the increase of the exports (1% y/y) and the reduction of the imports (-0.2%). Our preliminary projections indicate a mild recovery for 2014 (0.8% y/y) supported basically by an upturn of the investment (4.1%) and a timid recovery of the private consumption (0.1%) (Chart 26)

Deficit target of 5% achieved for 2012

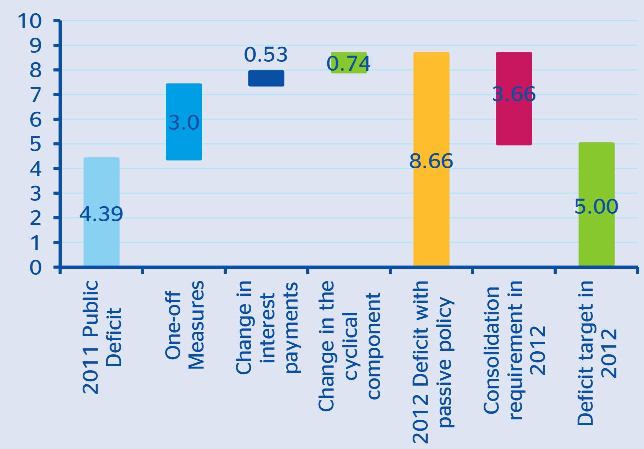
The fiscal effort carried out during 2012 (approx. 3.7% of GDP) was enough to achieve the deficit target of 5% agreed with the troika, although confirmation of inclusion of the revenue obtained from the concession of airports is still pending (800 million Euros; approx. 0.5% of GDP). Such fiscal effort consisted mainly of spending reduction measures (suspension of pension revaluation, 0.4% of GDP and personnel reduction, 0.2% of GDP); although it is also based on one-off measures, as the already mentioned airports concession (Chart 24).

The fiscal consolidation in 2013 is mainly supported by a higher revenue collection

For 2013, the target of 4.5% of GDP could be achieved with the fiscal effort forecasted by the government (3.2% of GDP). This year, the main compensation will be for the temporary measures applied in 2012 (approx. 1.7% of GDP), the deterioration of the cyclical deficit (0.2% of GDP), reduction of the deficit target (0.5 of GDP) and a higher interest payment estimated (0.4% of the GDP) (chart 25)

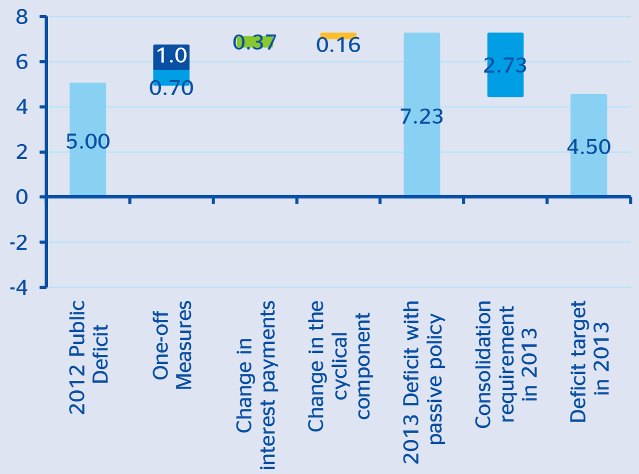
The fiscal effort for 2013 is mainly based on the forecasted increase of the fiscal revenue valued at 2.6% of GDP and a reduction of spending equivalent to 0.6% of GDP. The main measures that support the consolidation effort include, on the revenue side, the increase of the average income tax rate, from 9.8% to 11.8%; 13,2% if we add the bracket reduction and the extraordinary rate of 4% for higher incomes, with which an increase in revenue of approx. 2,810 million of Euros (1.7% of GDP) is expected. ; and on the spending side, the reduction of pension payments (from 3.5% to 10% for pensions greater than 1,350 Euros), which is aimed at reducing spending by 420.7 million Euros (0.3% of GDP).

Chart 24
Portugal: 2012 Deficit



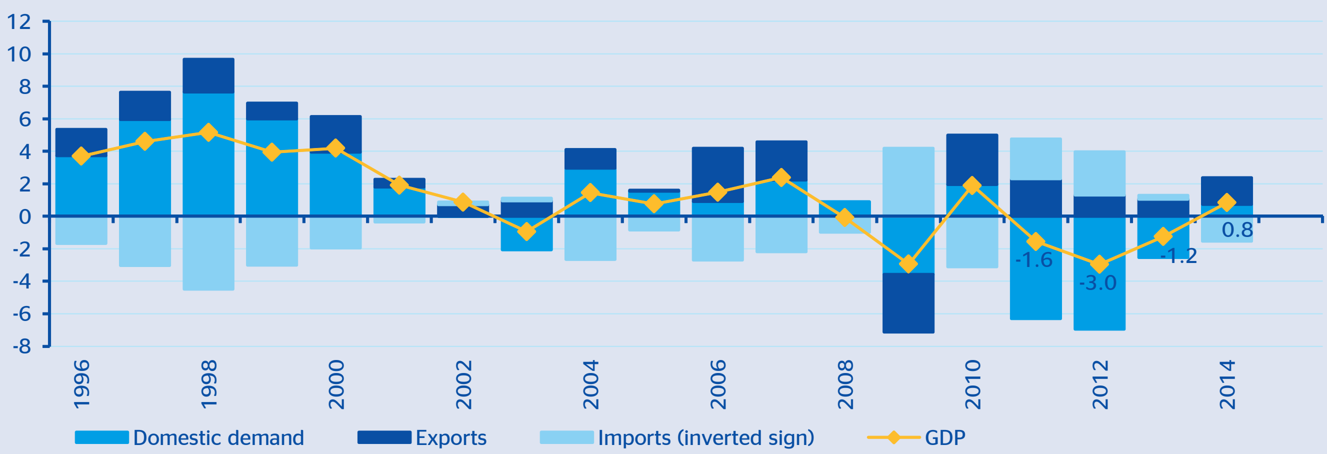
Source: BBVA Research

Chart 25
Portugal: 2013 Estimated Deficit



Source: BBVA Research

Chart 26
Portugal: GDP Growth Contribution (% q/q)



Source: BBVA Research

Box 4. United Kingdom: After 2012's standstill, a slow, sustained recovery of economic activity is expected for 2013

A new decline in the economic activity in 4Q12 due not only to temporary factors...

GDP fell by 0.3% q/q in the last quarter of the year, a little more than expected (BBVA Research: -0.1% q/q). This new fall had already been partly anticipated, as the transient boosting effect of the Olympic Games in 3Q12 would reverse in 4Q12. However, even taking this effect for granted, the economy may have dropped by approximately 0.1% q/q.

Although the decomposition of GDP on the demand side had not yet been published , the indicators available for 4Q12 suggest that the main obstacle for the economy might have been a new decline in exports, encumbered basically by the sharpening of the recession in the Eurozone, (45% of its total exports), but also by the slowing of the North American economy (16% of the total), as well as the strengthening of the sterling pound against the Euro over last year (around 7%). The later fact may have also translated into a significant downturn of the current account balance (by 2 pp down to -3.6% of GDP in 2012).

Regarding domestic demand, it may have remained stagnant owing to the slowdown in private spending, in line with the slight fall in retail sales (-0.6% q/q), while investment may have grown again after the decline seen in the previous quarters as the capacity used by businesses is already above its historical average. Lastly, also public consumption may have somewhat drained growth in the final part of the year after the strong rebound in the first quarter.

... that has resulted in a standstill of the economy in 2012, though there are indications of a slight recovery in sight already in 1Q13

As a result, the British economy may have stagnated in 2012, since the relative robustness of domestic demand (0.9 pp) may have been offset by the decline in foreign demand (-0.9 pp).

The first data on activity for 1Q13 (only confidence for January) point out to a somewhat more positive landscape. The confidence survey of the European Commission especially, as well as the GfK consumer confidence survey suggest stronger support from domestic demand, although they do not show clear signs of a better evolution of foreign demand.

The labour market will continue to underpin household expenditure in the projection horizon

The robustness of the labour market in a stagnant economy was a positive surprise over 2012. Employment rates rose by approximately 1% until 3Q12. This was especially the case of temporary work (2.3%), and reflected in a reduction in the unemployment rate of around half a point from early 2012, down to the 7.7% seen in November. This has also favoured an increase in salaries (around 3%), which, albeit partly limited by the decline in productivity (a little more than 1% until 3Q12), were above inflation (which slowed down by nearly 2 pp over the year). This resulted in an increase of the real income available to households (1.8% in the first three quarters of 2012). Notwithstanding this, in spite of the launch of the fund for increasing credit facilities (FLS) in mid-year, the credit made available to businesses has not stopped dropping (-3.2%) and neither has consumer credit (-1.5%). The FLS only reflects in an increase of credit for home buyers (1.1%); still, we expect that the conditions of access to credit will continue to be restrictive.

For the projection horizon, we expect that the labour market will continue to resist in spite of certain moderation of the pace of job creation, which, together with the increase in salaries, will help maintain household expenditure. Notwithstanding this, consumer confidence is still at very low levels and, although it will gradually rise as recovery is consolidated, if we add this to all of the above we can say that we do not anticipate a strong recovery of private spending in 2013 (1.2% after 1% in 2012). For 2014, households' consumption will rise again up to 2%, albeit still below the growth rates seen before the crisis.

The improvement in the Eurozone might imply a lesser burden for the British economy and a rebound of investment in 2013 and especially 2014

For 2013, our forecasts indicate a rebound of exports (2.3% after -0.4% in 2012), underpinned by the incipient recovery of the whole of the Eurozone as well as the expected devaluation of the pound (around 6%). Exports will also be supported by the robust recovery of the North American economy. In any event, it is fitting to point out that this evolution of exports entails a risk for our scenario in view of the loss of competitiveness that the British economy has been showing, with an increase in labour costs of around 3% in 2012 and an accumulated 12.5% since the start of the crisis in 2008. Although the growth of exports will also accelerate, foreign demand will eventually drain less growth (–0.2 pp against –0.8 pp in 2012). Additionally, the increase in exports will foster investment (3.8%), underpinned by the rising expectations of foreign demand after the stagnation of 2012.

The deficit reduction plan is maintained, but the debt reduction objective is delayed

The government presented in December its report on the state of public balances, together with the projections of the Office for Budget Responsibility (OBR). This report showed that funding needs in 2012-13 decreased substantially – by around 11,000 million pounds, 0.8% of GDP – as a consequence of the Bank of England's transfer of the excess of liquidity of the asset purchase programme. The OBR estimates that the deficit will drop in the year 2012-13 to 5.1% of GDP from 7.9% in the previous fiscal year. Still, it should be noted that this includes important temporary measures, apart from the transfer by the Bank of England: 28,000 million from the transfer of Royal Mail (1.8% of GDP) and 3,500 million from the sale of the 4G licence (0.2% of GDP). However, the data on budget execution until December were disappointing, already virtually reaching the deficit projected for the entire fiscal year by the OBR. As a result, a mere extrapolation of the data obtained one year before would show a deficit increased by approximately 0.5% of GDP.

For the fiscal year 2013-14, additional funding needs will amount to 2,000 million pounds. A number of measures for a half of this figure (repatriation of taxes in Switzerland and a cut in the expenditure of governmental offices) were already presented in December, and will also be more than enough to offset the removal of the fuel tax and the increase in the minimum personal exemption, as well as an increase in expenditure in public investment. Bearing these new measures in mind, it is estimated that the deficit might rise again up to 6.1% of GDP. Still, the final budget for the following fiscal year will only be presented in March.

The government is determined to pursue its fiscal consolidation programme to bring the deficit below 3% in 2016-17. However, it was announced that the public debt reduction objective will not be met in 2015-16, but it will be postponed one year so as not to increase the cuts, which thus heralds one more year's austerity.

Slow recovery in 2013, gaining momentum in 2014 to grow around its potential

The fiscal consolidation will be the main burden for economic growth over the projection horizon, which will reflect in a decline in public consumption in both 2013 (–1.1%) and 2014 (–1.7%).

Owing to the poorer performance of the economy in the final part of 2012, we have revised our growth forecast slightly downwards – by 0.3 pp down to 1% – this year. It still points out to a slow but sustained recovery that will gain momentum in mid-year to grow by approximately 2% in 2014, around its potential growth, underpinned by the robust domestic demand (1.7 pp) and greater support from the foreign sector (0.2 pp). In spite of all this, the production observed at the end of the projection horizon may be only around the levels attained before the crisis.

Inflation will remain above the objective until 2014

In spite of the strong inflation slowdown in 2012 down to an average of 2.8% from 4.5% in 2011, inflation picked up again to 2.7% in December, mainly as a response to the increasing prices of the underlying component. Bearing in mind the slight rise in the price of raw materials, especially oil, as well as the devaluation of the pound and an increase in labour costs, we now expect that inflation will remain above 2% in 2013 (2.5%), although it will become increasingly moderate until it attains an average annual growth around the objective in 2014 (2%).

This scenario points to a maintaining the monetary policy stance in 2013

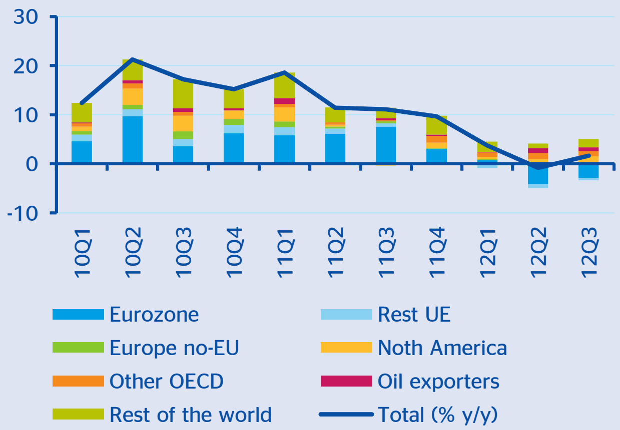
In view of this scenario in relation to both growth and inflation, we expect that the Bank of England will maintain the direction of its monetary policy in 2013, with the reference interest rate at 0.5% and a frozen asset purchase programme (375,000 million pounds). There are several reasons for this.

Firstly, maintaining inflation above the objective since 2006 is still damaging the credibility of the monetary authority, even if a debate on the adequacy of the inflation objective has been opened, now spurred by the next governor's statements. Secondly, there are growing doubts on the effectiveness of non-standard measures in a context of break of the traditional monetary policy transmission channels. This may make the Bank of England wait to see how the fund launched by the government to increase credit to the private sector (FLS) works.

In any event, there are indeed clearer signs that the opt-out strategy does not seem imminent, as shown by the reinvestment of the amortization of the 6,600-million-pound asset purchase in March.

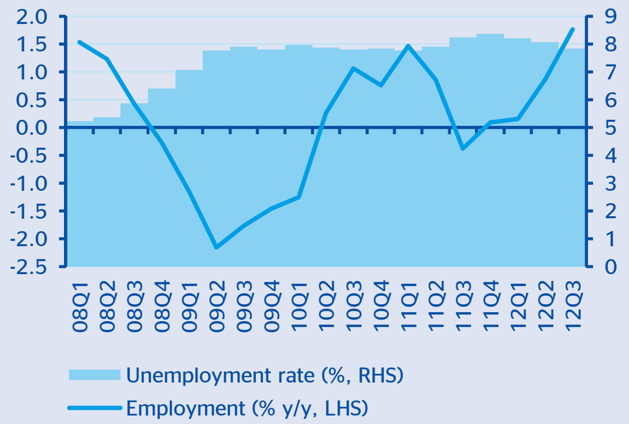
For 2014, if the consolidation of recovery is confirmed and inflation remains around the objective, the Bank of England is likely to begin increasing the reference interest rate from the second quarter.

Chart 27
UK: Contribution to annual exports growth by destination



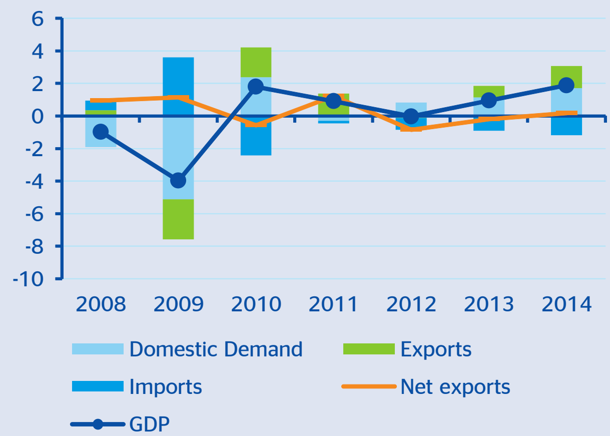
Source: ONS and BBVA Research

Chart 28
United Kingdom: Labor market



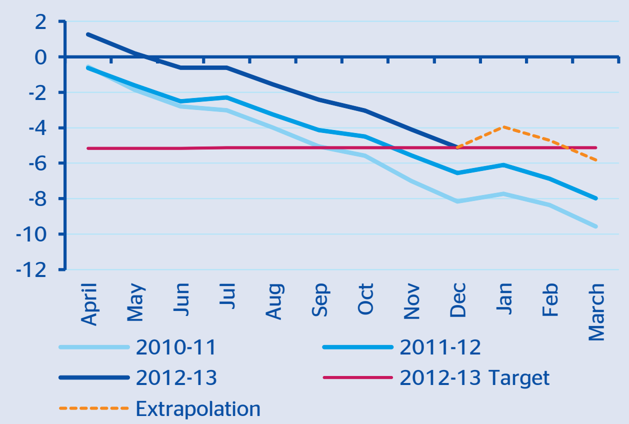
Source: ONS and BBVA Research

Chart 29
United Kingdom: Annual contribution to growth (pp)



Source: ONS and BBVA Research

Chart 30
UK: Public sector net borrowing excluding financial interventions (% of GDP)



Source: ONS and BBVA Research

5. Tables

Table 2
Eurozone forecasts

(YoY)	2009	2010	2011	2012	2013	2014
GDP at constant prices	-4.3	2.0	1.5	-0.5	0.3	1.3
Private consumption	-0.9	0.9	0.1	-1.2	-0.3	0.9
Public consumption	2.6	0.7	-0.1	-0.2	-0.5	0.2
Gross Fixed Capital Formation	-12.7	-0.3	1.6	-3.8	-1.3	3.3
Inventories (*)	-0.9	0.6	0.2	-0.5	0.0	0.0
Domestic Demand (*)	-3.6	1.2	0.5	-2.0	-0.5	1.2
Exports (goods and services)	-12.4	11.0	6.5	3.1	3.3	3.8
Imports (goods and services)	-11.0	9.5	4.3	-0.4	1.8	3.8
External Demand (*)	-0.8	0.7	1.0	1.5	0.8	0.2
Prices and Costs						
CPI	0.3	1.6	2.7	2.5	1.6	1.5
CPI Core	1.3	1.0	1.7	1.8	1.5	1.5
Labour Market						
Employment	-1.8	-0.5	0.5	-0.7	-0.5	0.4
Unemployment rate (% of labour force)	9.6	10.1	10.2	11.4	11.8	11.4
Public Sector						
Surplus (+) / Deficit (-) (% GDP)	-6.3	-6.2	-4.1	-3.0	-2.3	-1.8
Public debt (% GDP)	79.6	85.5	87.3	89.6	90.3	89.9
External Sector						
Current Account Balance (% GDP)	-0.2	0.0	0.1	1.1	1.3	1.4

(*) Contribution to GDP growth
Source: BBVA Research

Table 3
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2010	2011	2012	2013	2014
United States	2.4	1.8	2.2	1.8	2.3
Eurozone	1.9	1.5	-0.5	0.3	1.3
Germany	4.0	3.1	0.9	1.0	2.0
France	1.6	1.7	0.0	0.4	1.5
Italy	1.8	0.6	-2.1	-0.7	0.9
Spain	-0.3	0.4	-1.3	-1.1	1.1
UK	1.8	0.9	0.0	1.0	1.9
Latin America *	6.2	4.3	2.8	3.5	3.7
Mexico	5.4	3.9	3.9	3.1	3.1
Brazil	7.6	2.7	0.9	3.6	4.0
EAGLES **	8.4	6.6	5.1	5.8	6.1
Turkey	9.2	8.5	2.6	4.4	5.5
Asia Pacific	8.2	5.7	5.2	5.6	5.8
China	10.4	9.2	7.7	8.0	8.0
Asia (exc. China)	6.7	3.4	3.6	4.0	4.4
World	5.1	3.9	3.2	3.6	4.1

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: February 11, 2013
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2010	2011	2012	2013	2014
United States	1.6	3.1	2.0	2.1	2.2
Eurozone	1.6	2.7	2.5	1.6	1.5
Germany	1.2	2.5	2.1	1.7	1.6
France	1.7	2.3	2.2	1.5	1.5
Italy	1.6	2.9	3.3	2.0	1.7
Spain	1.8	3.2	2.4	2.0	1.1
UK	3.3	4.5	2.8	2.5	2.0
Latin America *	6.4	8.0	7.5	8.1	8.3
Mexico	4.2	3.4	4.1	3.5	3.7
Brazil	5.0	6.6	5.4	5.9	5.8
EAGLES **	5.3	6.0	4.2	4.4	4.5
Turkey	8.6	6.2	8.5	5.3	5.0
Asia Pacific	3.6	4.8	3.0	3.3	3.5
China	3.3	5.4	2.6	3.3	4.0
Asia (exc. China)	3.7	4.3	3.3	3.3	3.2
World	3.8	5.2	4.1	3.9	3.9

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: February 11, 2013
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Current Account (% GDP)

	2010	2011	2012	2013	2014
United States	-3.1	-3.1	-3.1	-3.1	-3.7
Eurozone	0.0	0.1	1.1	1.3	1.4
Germany	6.0	5.7	5.8	5.0	4.5
France	-1.6	-2.0	-1.9	-1.8	-1.7
Italy	-3.5	-3.1	-1.6	-1.2	-1.1
Spain	-4.5	-3.5	-1.4	0.3	0.9
UK	-3.9	-1.6	-3.6	-2.8	-2.6
Latin America *	-0.7	-0.9	-1.4	-1.6	-1.6
Mexico	-0.4	-1.0	-1.0	-1.4	-1.2
Brazil	-2.2	-2.1	-2.3	-2.6	-2.9
EAGLES **	1.5	0.8	0.4	0.4	0.6
Turkey	-6.4	-10.0	-7.5	-7.4	-7.4
Asia Pacific	3.3	2.0	1.2	1.3	1.7
China	4.0	2.8	2.6	2.8	3.5
Asia (exc. China)	2.0	1.5	0.3	0.2	0.5

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: February 11, 2013
Source: BBVA Research

Table 6
Macroeconomic Forecasts: Government Deficit (% GDP)

	2010	2011	2012	2013	2014
United States	-8.9	-8.7	-7.3	-5.9	-4.3
Eurozone	-6.2	-4.1	-3.0	-2.3	-1.8
Germany	-4.1	-0.8	0.1	-0.1	0.0
France	-7.1	-5.2	-4.5	-3.2	-2.5
Italy	-4.3	-3.8	-2.8	-2.0	-1.7
Spain *	-9.7	-9.0	-7.2	-5.9	-4.6
UK	-9.6	-7.9	-5.1	-6.1	-5.2
Latin America **	-2.4	-2.3	-2.5	-2.0	-1.8
Mexico	-3.4	-2.7	-2.6	-2.3	-2.2
Brazil	-2.5	-2.6	-2.5	-1.9	-1.7
EAGLES ***	-2.5	-1.9	-2.2	-2.0	-1.9
Turkey	-3.6	-1.4	-1.8	-1.6	-1.3
Asia Pacific	-3.6	-3.7	-3.6	-3.5	-3.0
China	-2.5	-1.1	-2.0	-2.0	-1.8
Asia (exc. China)	-4.5	-5.5	-4.7	-4.5	-3.8

* Excluding aid to financial sector
** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
*** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: February 11, 2013
Source: BBVA Research

Table 7
Financial Variables

Official Interest Rates (End period)	**2010**	**2011**	**2012**	**2013**	**2014**
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	0.75	0.75	1.25
China	5.81	6.56	5.75	6.00	6.00
10-year Interest Rates (Avg.)					
United States	3.2	2.8	1.8	2.0	2.6
EMU	2.8	2.6	1.6	2.0	2.9
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.76	0.72	0.78	0.77	0.75
EMU	1.33	1.39	1.29	1.31	1.34
UK	1.55	1.60	1.59	1.52	1.53
China (RMB per USD)	6.77	6.46	6.31	6.16	6.02

Forecast closing date: February 11, 2013
Source: BBVA Research

Table 8
Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	0.6	0.3	0.8	1.7	0.6	0.9	1.3
Public consumption	3.2	3.0	1.7	1.0	1.0	0.9	1.1
Gross Fixed Capital Formation	0.6	-11.5	5.6	6.4	-1.8	1.6	4.7
Inventories (*)	-0.1	-0.8	0.6	0.2	-0.5	0.0	0.0
Domestic Demand (*)	**0.9**	**-2.2**	**2.4**	**2.4**	**-0.3**	**0.9**	**1.7**
Export	2.3	-12.8	13.4	7.9	4.3	3.7	5.3
Import	3.0	-8.0	10.9	7.5	2.2	4.1	5.6
Net export (*)	**-0.1**	**-2.9**	**1.6**	**0.6**	**1.2**	**0.1**	**0.3**
GDP	**0.8**	**-5.1**	**4.0**	**3.1**	**0.9**	**1.0**	**2.0**
Inflation	**2.8**	**0.2**	**1.2**	**2.5**	**2.1**	**1.7**	**1.6**

(*) Contribution to growth
Source: BBVA Research

Table 9
France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	0.2	0.3	1.5	0.3	-0.1	0.3	1.2
Public consumption	1.2	2.6	1.7	0.8	1.4	0.0	0.7
Gross Fixed Capital Formation	0.1	-10.4	1.0	2.6	0.3	0.2	2.6
Inventories (*)	0.3	-1.3	0.1	1.0	-0.9	0.0	0.0
Domestic Demand (*)	**0.2**	**-2.6**	**1.6**	**1.7**	**-0.6**	**0.2**	**1.4**
Export	-0.6	-11.8	9.2	4.6	2.5	2.4	4.3
Import	0.6	-9.5	8.4	5.3	0.2	1.7	3.9
Net export (*)	**-0.4**	**-0.5**	**0.0**	**0.0**	**0.6**	**0.2**	**0.1**
GDP	**-0.2**	**-3.1**	**1.6**	**1.7**	**0.0**	**0.4**	**1.5**
Inflation	**3.2**	**0.1**	**1.7**	**2.3**	**2.2**	**1.5**	**1.5**

(*) Contribution to growth
Source: BBVA Research

Table 10
Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	-0.8	-1.6	1.2	0.1	-4.2	-1.7	0.3
Public consumption	0.6	0.8	-0.6	-0.8	-1.1	-2.0	-0.5
Gross Fixed Capital Formation	-3.8	-11.7	2.0	-1.3	-8.9	-1.8	2.8
Inventories (*)	0.0	-1.1	1.2	-0.5	-0.5	0.0	0.0
Domestic Demand (*)	**-1.2**	**-4.3**	**2.1**	**-0.9**	**-4.9**	**-1.7**	**0.6**
Export	-2.8	-17.7	11.2	6.7	1.7	2.3	4.3
Import	-2.9	-13.6	12.3	1.2	-8.3	-1.0	3.6
Net export (*)	**0.0**	**-1.2**	**-0.4**	**1.5**	**2.8**	**0.9**	**0.4**
GDP	**-1.2**	**-5.5**	**1.8**	**0.6**	**-2.1**	**-0.7**	**0.9**
Inflation	**3.5**	**0.8**	**1.6**	**2.9**	**3.3**	**2.0**	**1.7**

(*) Contribution to growth
Source: BBVA Research

Table 11
Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	1.3	-2.3	2.5	-3.8	-5.3	-2.1	0.1
Public consumption	0.3	4.7	0.1	-4.3	-4.4	-2.1	0.3
Gross Fixed Capital Formation	-0.3	-8.6	-3.1	-10.7	-13.8	-5.6	4.1
Inventories (*)	0.0	-1.1	0.9	-0.7	0.0	0.1	0.0
Domestic Demand (*)	**0.9**	**-3.6**	**2.0**	**-6.3**	**-6.9**	**-2.5**	**0.7**
Export	-0.1	-10.9	10.2	7.2	3.7	2.8	4.2
Import	2.3	-10.0	8.0	-5.9	-6.8	-0.6	4.0
Net export (*)	**-1.0**	**0.6**	**-0.1**	**4.7**	**4.0**	**1.3**	**0.1**
GDP	**-0.1**	**-2.9**	**1.9**	**-1.6**	**-3.0**	**-1.2**	**0.8**
Inflation	**2.7**	**-0.9**	**1.4**	**3.6**	**2.8**	**1.0**	**1.1**

(*) Contribution to growth
Source: BBVA Research

Table 12
Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	-0.6	-3.8	0.7	-1.0	-1.9	-2.8	-0.3
Public consumption	5.9	3.7	1.5	-0.5	-4.0	-7.2	-1.8
Gross Fixed Capital Formation	-4.7	-18.0	-6.2	-5.3	-9.0	-6.8	2.6
Equipment and other products	-2.9	-23.9	2.6	2.3	-6.1	-1.5	6.4
Construction	-5.8	-16.6	-9.8	-9.0	-11.5	-10.2	0.3
Housing	-9.1	-23.1	-10.1	-6.7	-7.1	-8.3	2.1
Other construction	-1.6	-9.1	-9.6	-11.0	-15.5	-12.2	-1.6
Inventories (*)	0.1	0.0	0.1	-0.1	0.0	0.0	0.0
Domestic Demand (*)	**-0.5**	**-6.6**	**-0.6**	**-1.9**	**-3.8**	**-4.6**	**0.0**
Export	-1.0	-10.0	11.3	7.6	3.3	6.3	8.2
Import	-5.2	-17.2	9.2	-0.9	-4.7	-4.4	5.8
Net export (*)	**1.4**	**2.9**	**0.3**	**2.3**	**2.5**	**3.4**	**1.1**
GDP	**0.9**	**-3.7**	**-0.3**	**0.4**	**-1.4**	**-1.1**	**1.1**
Inflation	**4.1**	**-0.3**	**1.8**	**3.2**	**2.4**	**2.0**	**1.1**

(*) Contribution to growth
Source: BBVA Research

Table 13
UK: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013	2014
Private consumption	-1.6	-3.1	1.3	-1.0	1.0	1.2	2.0
Public consumption	1.6	0.8	0.4	-0.1	2.8	-1.1	-1.7
Gross Fixed Capital Formation	-4.6	-13.7	3.5	-2.9	0.0	3.8	5.6
Inventories (*)	-0.4	-1.0	0.9	0.7	-0.4	0.2	0.0
Domestic Demand (*)	**-1.9**	**-5.1**	**2.4**	**-0.3**	**0.8**	**1.1**	**1.7**
Export	1.2	-8.2	6.4	4.6	-0.4	2.3	4.3
Import	-1.8	-11.0	8.0	0.5	2.3	2.8	3.5
Net export (*)	**0.9**	**1.1**	**-0.6**	**1.2**	**-0.8**	**-0.2**	**0.2**
GDP	**-1.0**	**-4.0**	**1.8**	**0.9**	**0.0**	**1.0**	**1.9**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.5**	**2.0**

(*) Contribution to growth
Source: BBVA Research

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