

Europe

Economic Outlook

Fourth Quarter 2010

Economic Analysis

- Eurozone recovery is slowing in the second half of 2010, but not too rapidly.
- Moderate growth still expected for the next years.
- With inflation clearly below 2% and the Fed easing further, the ECB will keep rates unchanged for the foreseeable future.
- Financial stress in Europe is still a source of concern, though systemic risk is slightly lower than before the summer.



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Closing date: October 29, 2010

1. Global outlook: Slow North, fast South

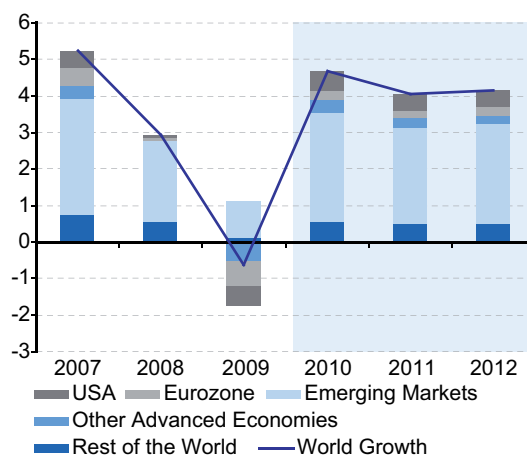
The global economy keeps growing strongly, mostly in emerging countries, whereas cyclical and financial concerns dominate advanced economies

Global growth continues to be strong, and is expected to reach 4,7% in 2010, and 4,1% in 2011 (Chart 1), mostly unchanged with respect to our forecast three months ago. This encouraging performance is mostly due to strong outturns in emerging economies, which have been less affected by the financial crisis, as their banking sector was in very good shape, and have thus recovered rapidly. In contrast, renewed cyclical concerns in the US have joined financial concerns still dominating Europe, where macroeconomic and financial adjustments are still underway. Thus, in line with our expected scenario, the outlook for the next two years continues to highlight the growth gaps between the advanced north and the emerging south (Chart 2) even if the latter also embarks on a controlled slowdown to ameliorate the risk of overheating.

But there are also significant policy differences inside each of these groups. In the US, monetary expansion is set to intensify in relative terms with respect to Europe (and most other countries), thus depreciating the dollar against the euro and complicating Europe's recovery. In emerging economies, a strong asymmetry in exchange rate policy between Asia and Latin America continues, forcing the latter to bear (together with the euro) a disproportionate part of the exchange rate appreciation derived from renewed monetary easing in the US.

Chart 1

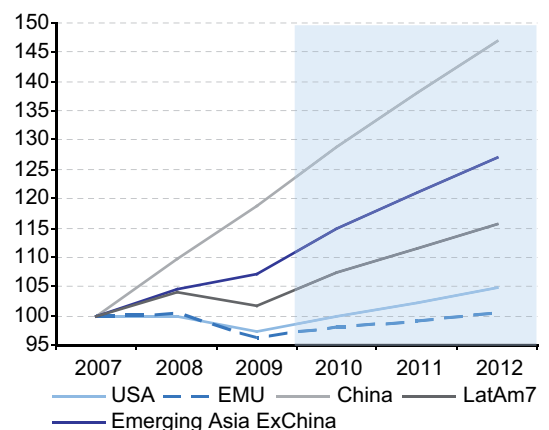
Global GDP growth and contributions



Source: BBVA Research

Chart 2

GDP level: 2007=100



Source: BBVA Research and Datastream

Growth in the US will remain low given ongoing household deleveraging, but a double dip scenario is very unlikely

Over the last quarter, relatively weak indicators of economic activity in the US have raised the specter among market participants of a possible relapse into a recession –a double dip in economic activity–. The weakness observed in some key sectors that had benefited directly from fiscal support through incentives for purchases (durable goods and housing) is a strong signal that the recovery in private sector demand is still not self sustaining. This weakness is a consequence of an ongoing household deleveraging process and a weak labor market, which will continue to push households to save more than what was observed since the second half of the 1990s. Even though this is to be welcomed in the process of rebalancing growth in the US, it increases cyclical concerns since consumption (one of the pillars of recovery in past recessions) will remain muted and only partially compensated by stronger investment in equipment by firms and exports.

Recent concerns about the health of the housing sector are, in our view, excessive and the possibility of a relapse into further significant real estate price drops is very small, given that prices have declined by about 30%. There are certainly elements of concern, such as elevated house inventory levels and the potential impact of an unexpected further supply of housing from new foreclosures, which may come either from increased delinquencies or due to owners walking away from increasingly negative housing equity. But there are also elements of support, such as the huge gains in housing affordability

since the crisis started and the demographic trends that should help prop up demand going forward . It is true that if house prices continue to decline, it might have a non-negligible impact on consumption, but at least the banking system seems in a relatively good shape to withstand a moderate shock to prices. All in all, the scenario of further significant price drops is highly unlikely. Instead, a period of relatively stable house prices seems more likely, while past excesses are finally reabsorbed.

Overall, the drags on consumption and the low probability of further fiscal stimulus –out of concerns about the size of current deficits and the political arena – imply an exit from the crisis in the US at a pace much lower than in previous cycles (Chart 3), as we have been forecasting for a long time. While the probability of a double dip in the US is low, in any case, the lack of strength of domestic demand will induce the US more and more to press the rest of the world (especially countries with a current account surplus and high domestic saving rates) to increase their demand and contribute to the necessary global rebalancing. The renewed monetary expansion in the US can be interpreted in this context as one way to force part of this adjustment onto the rest of the world.

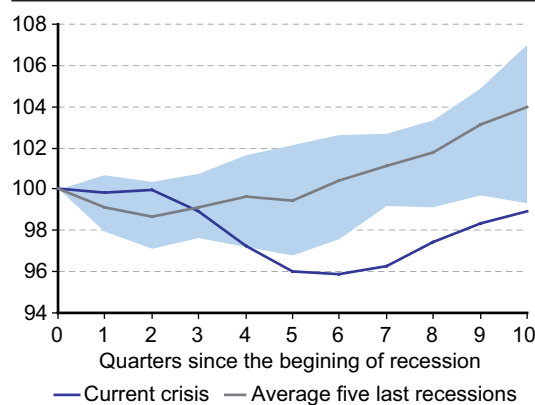
Financial stress in Europe is still a source of concern, though systemic risk is lower than before the summer. Fiscal consolidation remains crucial to sustain confidence, and will not have a large negative impact on growth beyond the short-term

After decisive advances in fiscal consolidation, measures to provide support to distressed governments and especially after the financial sector stress tests, there has been a qualitative change in the dynamics of the crisis in Europe. On the one hand, even if average sovereign spreads have remained relatively stable, markets have highlighted the differentiation between sovereign assets, thus reducing the risk of a systemic event. In addition, financial markets have started to open –though selectively– and renewed debt issuance is a further sign of lower tensions.

Notwithstanding this, financial market stress in Europe is still the main source of risk for the region (Chart 4) especially given the link between sovereign concerns and risks to the financial sector, given their national and cross-border exposure. In addition, the recent strengthening of the euro means an added challenge given that best performing economies had been supported by external demand. This makes it more imperative to tackle decisively in the short run the sources of macroeconomic vulnerability in the region, namely fiscal sustainability and external imbalances, as well as avoiding further delays in restructuring the weak part of banking systems. The key is to continue rebuilding confidence to reduce market tensions and rebuild the autonomous strength of private sector demand. In addition, to sustain growth in the long run, it will be crucial to undertake much needed structural and institutional reforms, the latter especially geared towards preventing and resolving future fiscal imbalances.

Chart 3

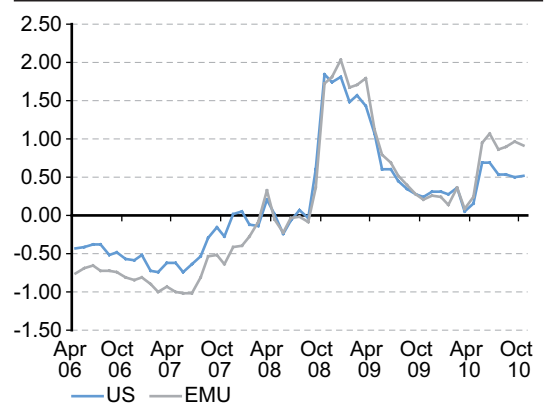
**US GDP: current cycle vs. previous recessions*.
Beginning of each recession=100**



* Shaded area: range of GDP during last 5 recessions
Source: BBVA Research and NBER

Chart 4

Financial Stress index



Source: BBVA Research

Monetary policy in advanced economies will be lax for a long time, adding pressure to exchange rates worldwide

Prospects of very low growth and subdued inflationary pressures in advanced economies will translate into low interest rates for a prolonged period in the three most important advanced areas (US, Europe and Japan). However, against the backdrop of renewed cyclical concerns and the much-reduced scope for further fiscal stimulus, markets were focused on the US embarking into a new bout of unconventional monetary easing (so-called Quantitative Easing 2, or QE2). The expectation of this further increase in liquidity lowered the exchange rate of the dollar across the board, including vis-à-vis the euro. Going forward, given that most of QE2 has been already priced in by markets, exchange rates should start to move more according to long-term fundamentals, meaning a strengthening of the dollar vis-à-vis the euro on account of better growth prospects and stronger investment inflows. At the same time, appreciating pressures on emerging economies will continue due to increased global liquidity, stronger macroeconomic fundamentals and positive return differentials favoring renewed capital inflows.

Emerging markets face increasing policy dilemmas from strong growth, abundant global liquidity and competitive foreign exchange interventions

Emerging economies continue to grow strongly, with emerging Asia leading the world recovery. In both Asia and Latin America, private domestic demand is taking over policy-induced stimulus as the source of the recovery. Going forward, growth in Asia will slow down as countries try to reign in domestic credit growth, thus reducing the risk of overheating. But the region will continue to contribute the most to global growth.

Both Asia and Latin America confront increasing monetary and exchange-rate policy dilemmas, between cooling strong domestic demand and preventing strong capital inflows and preserving competitiveness in foreign markets. Some countries have started introducing administrative measures to discourage strong capital inflows and some others have slowed their rate of monetary tightening.

Given the inflexibility of exchange rates in Asia (and China in particular), Latin America is facing a disproportionate part of the adjustment, to the point that further exchange-rate appreciations will start to be a problem for growth. Thus, many countries in the region are weighing further exchange rate interventions although experience shows that their effectiveness is rather limited, contributing mostly to slow down the rise in exchange rates, but not prevent them. The risk is that increased intervention into foreign exchange markets ends up sliding into retaliatory trade measures. This highlights the importance of increased exchange rate flexibility in Asia as a way to provide more policy space to the rest of the world.

2. Drivers for growth

Our previous outlook for the European economy, published at the end of July, was of a modest recovery. As the positive impulse from the recovery at a global level and the expected reduction of financial stress, together with the depreciation of the euro towards its equilibrium level of about 1.20 against the dollar, was expected to be offset to a certain extent by fiscal tightening effects and the persistent weaknesses of the European banking sector. Three months later, the perspective of these drivers for growth has changed substantially at the international level, as outlined in the previous section.

Global activity to decelerate in 2011

As the outlook for the US has been worse than expected, foreign demand will be weaker; not only due to direct effects but also through second round effects from emerging markets. Although it is unlikely that the impact is very large, it is clear that the more subdued pace of the global economy will also have an effect on worldwide confidence and the European economy.

Euro more appreciated than expected

As a result of the US economy weakness and the subsequent additional relaxation of the monetary policy not mimicked by the ECB, the euro has appreciated further against the dollar (and many other currencies). After a period of convergence towards its equilibrium level before the summer, the euro will remain far from it for some time. This will also affect eurozone exports, though we estimate the net effect will not be considerably larger than 0.3 percentage points below the previous scenario.

Financial market stress

The climate improved after the publication European stress tests, but worsened again as the problems of Irish banks spread through a contagion effect to sovereign bonds in Ireland, Greece, Portugal, and to other EU countries to a smaller extent. The good news is that contagion to Spain has diminished considerably, significantly reducing the systemic risk in the area.

Fiscal consolidation accelerates

There has been relatively little news on the fiscal front since the beginning of the summer. Budget execution proceeds broadly in line with previous plans (aside from some underperformance in Portugal and the impact of the bailout of a banking institution in Ireland). Announcements on public budgets for 2011 proceed in line with previous plans (see section 6 below), and thus consolidation will be extended to France, Italy and Germany in 2011 (after having started in Greece, Portugal, Spain and Ireland in 2010). Overall, we continue to think that the impact of fiscal measures on activity is not likely to be large.

Monetary policy continues to be accommodative

Because of the influence of the expected extension of quantitative easing measures in the US, its impact on the exchange rate, the persistence of financial tensions in Europe, and underlying problems in part of the banking sector, we continue to think that the ECB will maintain very low interest rates in the foreseeable future, despite recent rhetoric against this by some members of the ECB (see section 5 below).

3. Recent trends and projections for the eurozone

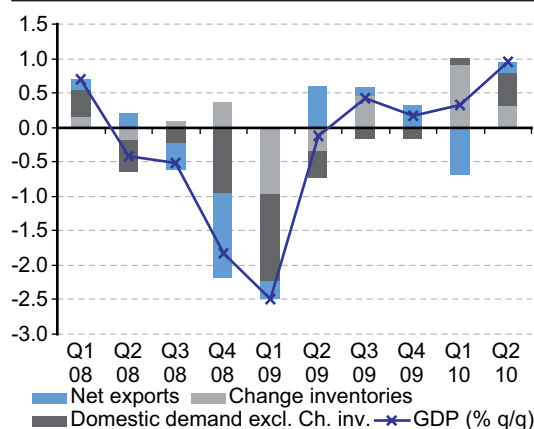
Eurozone GDP for the second quarter surged by 1% q/q, beating expectations and showing a more balanced growth composition

Activity in the eurozone has been beating expectations in the last few months. A growth rate of 1% q/q in the second quarter implies that GDP in the eurozone as a whole increased by 1.3% in H1 2010 over the same period of 2009. Since the beginning of the recovery in Q3 2009, GDP has increased by approximately 2%, which is still far from the fall of around 5% originated during the crisis.

Positive news came from a somewhat more balanced growth composition (Chart 5), with a strong contribution of domestic demand (0.8pp) that, unlike in the previous quarter, was driven by significant investment growth, although part of the recovery in investment could be temporary as housing investment in Northern Europe soared after a severe winter. In addition, private consumption rose, albeit mildly, for the third quarter in a row, while public consumption grew at a slower pace, as the fiscal impulse waned in most countries and others are already implementing fiscal consolidation measures. A more moderate contribution from the change in inventories is also noteworthy. The external sector has been affected positively by the robust global recovery, with a significant acceleration in exports, while the parallel increase in imports may be mostly due to the need for industrial inputs and inventory restocking. As a result, net exports contributed slightly to GDP growth with 0.2pp, after draining significantly in Q1.

Chart 5

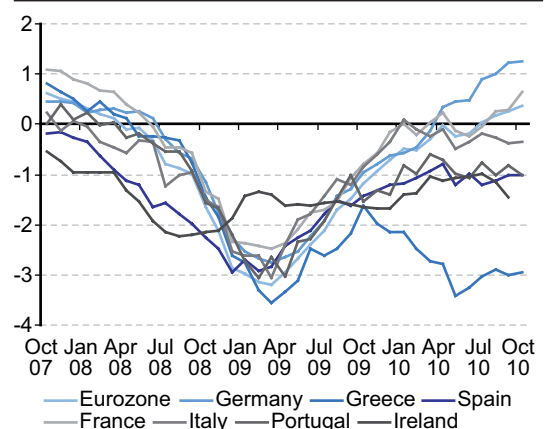
Eurozone:
Contribution to quarterly GDP growth



Source: Eurostat and BBVA Research

Chart 6

Eurozone: Economic sentiment



Source: European Commission and ESRI

Short-run indicators suggest that the economic recovery is on track in Q3, though far from the impressive growth in Q2. Soft data so far have shown no evidence of a sharp slowdown in Q4

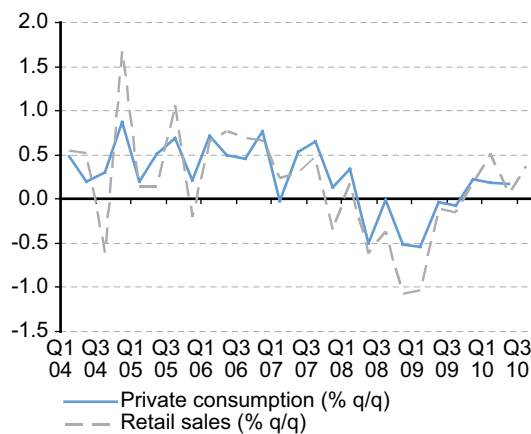
Hard and soft data available for Q3 confirm a clear decelerating trend in economic growth over the second half of the year, as a result of slower global economic growth, the waning momentum in the rebuilding of inventories and fiscal consolidation measures that have been undertaken in some countries. The slowdown should not be abrupt, though.

After strong resilience in confidence indicators up until August, the sharp slowdown observed in the PMI composite index in September was larger than expected, leaving the Q3 average below the one observed in the previous quarter, but suggesting that the underlying momentum remained positive. In contrast, economic sentiment from the European Commission survey unexpectedly increased in Q3, though at a more moderate pace than in previous quarters. Overall, national soft indicators showed further evidence of decoupling between the core and periphery (Chart 6).

Nevertheless, hard economic indicators available for Q3 have drawn a slightly less optimistic outlook for Q3. On the one hand, they showed that domestic demand is not strong enough to take the lead in driving the recovery from the external sector. In particular, retail sales declined again in August, signalling that private consumption is likely to remain subdued (Chart 7), influenced by the high unemployment rate. Additionally, the industrial production index showed more evidence that the industrial upswing slowed in Q3, as the cumulative growth up to August was around half that observed in the previous quarter, although the rebound of industrial orders in August showed more evidence that industrial output should continue to increase in coming months, after reaching a peak in Q2 (Chart 8). The latter, coupled with still low levels of capacity utilization, suggests that private investment will continue to be subdued, despite the strong rebound recorded in Q2 that was mainly due to temporary factors. In particular, construction output fell slightly again in August, cumulating a significant drop over Q2 and signalling that construction investment is likely to slow again in Q3. Regarding private lending, August's monetary data are consistent with an overall positive sentiment on improving conditions, but still with a very cautious tone, rather than signalling a marked recovery. Moreover, the support of exports to the recovery, though resilient, has weakened in Q3. Trade balance data for August confirmed that a decelerating trend in exports has been ongoing since Q2, after recovering from a cumulative drop of around 25%. Nevertheless, the larger increase in exports than in imports in July-August suggests that net exports should contribute to economic growth slightly in Q3.

Chart 7

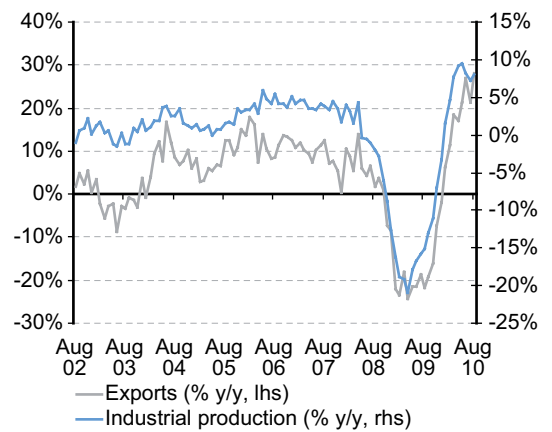
Eurozone: Households' consumption



Source: Eurostat

Chart 8

Eurozone: Industrial production and exports



Source: Eurostat

Overall, our economic synthetic indicator (Chart 9) points to growth of around 0.5% q/q in Q3 for the eurozone as a whole, with hard indicators available until August. For Q4, only flash PMI data for October have been released, showing a resilient industrial sector and suggesting that economic recovery should continue in the last quarter of the year, with no evidence of a sharp slowdown. The latter is in line with our macroeconomic scenario which envisages a moderation of growth to 0.3% q/q.

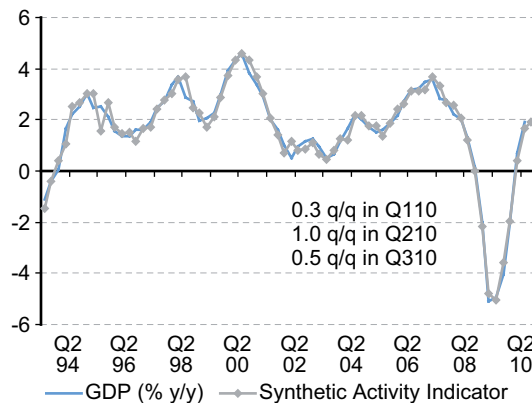
The labour market deterioration has halted, while hiring intentions improved

The unemployment rate in the eurozone has also performed somewhat better than expected, stabilizing at 10.1% in recent months. It has remained relatively stable since December 2009, when it arrived at 9.9%, after a 2.5pp increase during the recession. Nevertheless, national data showed once again the divergence between core and periphery countries, with unemployment declining slightly in the former and rising moderately in the latter, in line with discrepancies in GDP growth (Chart 10).

Eurozone employment remained flat in Q2 for the second quarter in a row, interrupting the sharp job losses caused by the crisis. These figures mean that employment has fallen around 2.5% since the second quarter of 2008, when negative GDP figures started to be registered. The detailed breakdown showed less encouraging signs as job losses continued in all sectors except in services. Despite the improvement over Q3 of managers' hiring intentions in surveys, we expect employment to stagnate, as economic growth slows down in the second half of the year.

Chart 9

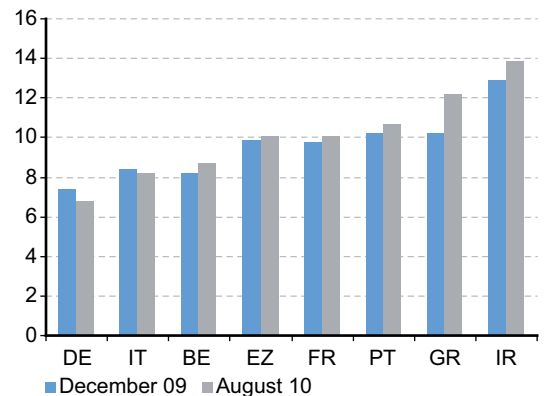
Eurozone: Synthetic activity indicator



Source: Eurostat and BBVA Research

Chart 10

Eurozone: Unemployment rate



Source: BBVA Research

Our medium term scenario is of a slowdown in coming quarters and more moderate average growth in 2011 and 2012

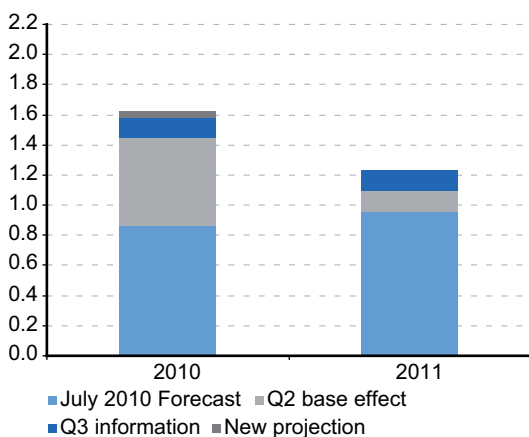
For 2010, our projection of GDP growth for the eurozone has been revised significantly upwards compared to the one presented in our July Europe Economic Outlook, from 0.9% to 1.6% (Chart 11), mainly due to the base effect resulting from stronger than expected growth printed in Q2, as well as upward revisions for Q1 data (explaining a revision of +0.5pp), and to a lesser extent because of incoming information for Q3 suggesting higher growth for the second half of the year (+0.2pp). We continue to incorporate a clear slowdown in the remainder of the year. As for 2011, we foresee slightly higher growth at 1.2% (as compared to 1% in July), while quarterly growth rates should be slightly below our previous forecast, driven mainly by continued financial stress and a more appreciated euro.

Overall, we do not see domestic demand taking the lead in driving the recovery over the forecast horizon; henceforth, the economic recovery is dependent on the strength of global economic growth:

- Employment is expected to be virtually flat in coming quarters, and thus the unemployment rate should remain at relatively high levels over the forecast horizon. Wages should grow at moderate rates, given the large unemployment gap. All this should result in sluggish growth of consumers' real disposable income, only supported by lower inflation and a decline in the precautionary savings rate, after it peaked in Q2 2009. This will constrain households' spending, together with tax hikes in several eurozone countries. On average, consumption is expected to increase by about half a percentage point in 2010 and slightly above 1% in both 2011 and 2012.
- Investment is likely to fall on average in 2010, as it is expected to stagnate in the second half of the year, given the scarce use of capacity utilization and the weakness of private demand. The declining pace of lending to non-financial corporations also confirms the low pulse of private investment. As long as the recovery sets in, the timid improvement in domestic demand along with a still more robust global demand, especially from emerging countries, will cause the capacity utilization of firms to return to pre-crisis levels. In addition, low interest rates and the normalization of the functioning of the financial system will enhance business investment that is expected to increase moderately in 2011, accelerating slightly in 2012.
- After some moderation in the first half of the year, public consumption is expected to slowdown further for the remainder of 2010, as some peripheral countries implement strong fiscal adjustments. As a result, government consumption will slow down substantially in 2010 to around 1% from rates above 2% observed in previous years. Furthermore, most member states will implement fiscal adjustment measures in 2011, causing public spending to slow again in 2011 and to remain weak in 2012.
- Exports are expected to decelerate somewhat in the second half of 2010, after having recovered from a cumulative drop of around 25%, but remaining still robust and growing on average at close to 9% for the entire year. For 2011, slowing global recovery, along with the strength of the euro, should affect exports negatively, moderating to an average annual growth of around 4.5%. Imports are projected to decelerate more deeply in the second half of the year, associated with a reduced need for inputs derived from the slowdown in the industrial sector recovery and the depletion of the

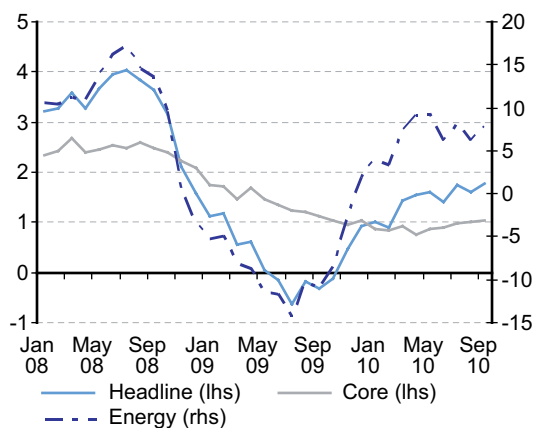
re-stocking process. They are expected to post an average annual growth of around 9% in 2010, with net exports having a flat contribution to GDP growth. For 2011, as final demand slows, imports should moderate further to 4%, resulting in a slight positive contribution of net exports to growth.

Chart 11
Eurozone: GDP annual growth



Source: BBVA Research

Chart 12
Eurozone: HICP inflation (% y/y)



Source: Eurostat

The labour market will deteriorate somewhat further in 2011 and then start recovering in 2012

The labour force is expected to increase only moderately in 2010, in a similar way as in 2009 when it grew by 0.2%, slowing significantly from rates of around 1% that had been recorded since early 2000. For the next two years, we estimate that the labour force will grow at rates slightly higher, of around 0.5%, but far from those levels previously recorded due to both an aging workforce and a decline in migration flows derived from sluggish economic growth. Despite the interruption of job losses in the first quarter, average employment is expected to decline by about half point in 2010 as a whole, increasing slowly both in 2011 and 2012, somewhat below the labour force growth. As a result, we see unemployment rate in the eurozone to remain relatively stable at around 10% for the forecast horizon.

Productivity in the eurozone is expected to rebound strongly in 2010 as a result of the increase in production and employment contraction, after falling sharply in 2009 and marginally in 2008. For 2011, productivity growth should slow down back to pre-crisis levels.

Headline inflation is expected to remain well under the ECB target in the medium term, with very subdued core inflation

Headline inflation increased further in Q3, by 0.2pp, to reach 1.7% y/y, after having surged in Q2 from 1.1% to 1.5% (Chart 12). The rise in both quarters hides different factors. In the second quarter, the main driver was the strong pick up in energy prices due to base effect as well as to higher oil prices, along with the depreciation of the euro; core inflation continued to slow down slightly (by 0.1pp) to 0.8% y/y. In contrast, in the third quarter, core inflation rose for the first time since mid-2008 to 1% y/y, partly because of tax hikes and partly because of the relative dynamism observed in private consumption. In addition, strains in food markets also ended up affecting consumer prices. Compared to our previous forecast, these data have surprised on the upside, as both VAT hikes and tensions in commodity markets were supposed to be more than offset by the weak economic momentum.

For the last quarter of the year, inflation is expected to increase timidly to around 1.9% y/y, as moderation is expected in energy prices resulting from the reversion of base effects and the recent appreciation of the euro, which should partly offset the rise of the barrel of Brent. Core inflation is also expected to increase by 0.1pp to 1.1% y/y, driven mainly by higher prices for both non-energy industrial goods and processed food, while service inflation will remain broadly stable. Overall, the annual average headline inflation rate will likely be at 1.6% and core inflation at 1%.

Looking forward, headline inflation is expected to moderate as from Q2 2011, driven by lower energy inflation (base effect), while core inflation should increase further in early 2011, remaining relatively stable for the remainder of the year. As a result, average inflation should be at 1.7% for headline and at 1.3% for core component, well below the ECB's target.

Risks go in both directions: an upward risk over the remainder of the year and clearly a more dangerous downward risk for next year

There is an upward risk if the recovery is stronger than projected and domestic demand starts carrying us forward. On the one hand, our estimate growth for the remainder of the year could be tilted to the downside, as available indicators do not suggest a very abrupt slowdown in the second half of the year, but we think it will not hinder greatly our annual average growth for 2010 as a whole. In addition, the upward bias due to healthier domestic demand recovery could mean a stronger recovery next year. However, they should be offset by some persistent downside risks that may have a negative effect in economic growth for 2011. For one, financial market strains do not disappear, being quite vulnerable to the uncertain performance of several peripheral countries in both banking and fiscal issues. In particular, additional fiscal retrenchment could be needed to consolidate national accounts. Furthermore, the divergence between monetary policies implemented by central banks could lead to a stronger euro over 2011, in contrast with our scenario of some depreciation, weakening the support of the robust global recovery.

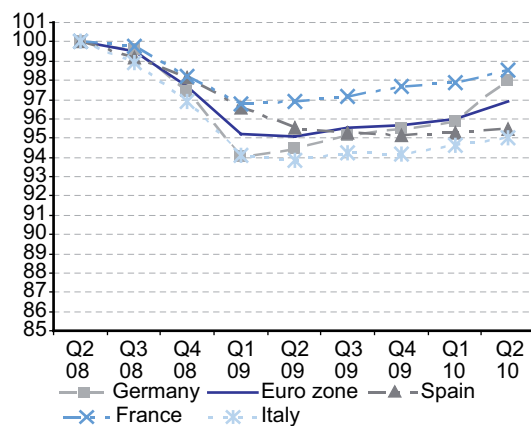
As for inflation, we think risks are broadly balanced, as upward pressures from strong industrial inflation and potential additional tax hikes could be offset by the weakness of private consumption and by a potential strengthening of the euro.

4. Member states: A closer view

Across countries, different growth rates will persist

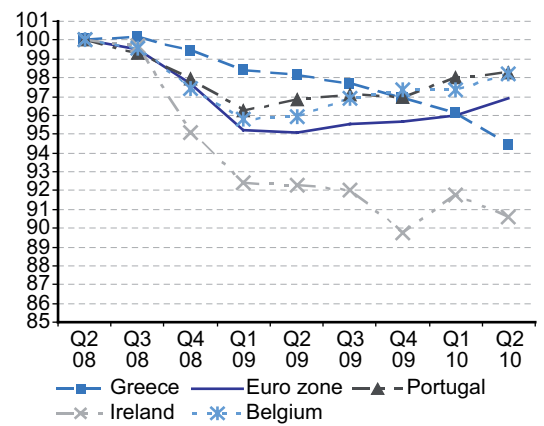
Differences between the core and the periphery are set to continue, after increasing significantly in recent quarters, because of higher financial tensions in the periphery, more imbalances to correct, and differentiated rhythms of fiscal adjustment (Charts 13, 14 and 19).

Chart 13
GDP core economies
(Index, T=100, T=2008Q2)



Source: Eurostat and BBVA Research

Chart 14
GDP Peripherals
(Index, T=100, T=2008Q2)



Source: Eurostat and BBVA Research

Germany: Leading growth in the eurozone, but also slowing down

Following an impressive and unexpected growth in Q2, recent hard and soft indicators suggest that the recovery is ongoing in the second half of the year, albeit clearly at a more moderate pace. On the one hand, retail sales and consumers' confidence along with goods news coming from labour market performance point to a stronger role of the domestic economy, making the export-led recovery more sustainable in H2 2010. Furthermore, the industrial recovery also continues on track at a moderate rate, while industrial orders rebounded again in August, suggesting that further industrial investment should be needed in coming months. Regarding public consumption, the German government is not carrying out any fiscal adjustments this year, so it does not adversely affect economic growth. On the external front, average growth of exports in July-August amounted 3% over Q2, slowing from the extraordinary export performance in that quarter, but remaining resilient after reaching pre-crisis levels. The performance in exports observed in recent months has been mainly driven by sales to non-eurozone countries, especially those to China (14% share) and the U.S. (17%), while growth exports to the eurozone were more moderate. Overall, the support of domestic demand to the recovery is likely to be larger than previously expected, despite its weakness, partly offsetting downside risks from lower net exports. Still, limited data showed further evidence that the economic outlook remains positive at the beginning of Q4, but expectations for the next 6 months also reveal further slowdown in the first half of 2011 (Chart 15).

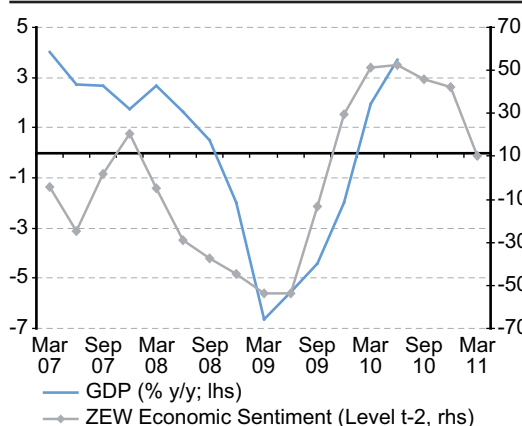
Overall, German GDP is projected to increase by 3.2% in 2010, with some upside risks from good data in early Q4, leading the eurozone recovery. The main driver of economic growth in 2010 continues to be exports, with a net exports contribution of around 1.1pp, also supporting the clear recovery of the industrial sector, and leading to robust private investment growth. Although private consumption growth is expected to continue in H2 2010, this component will not contribute to the economic recovery in 2010 as whole. For 2011, we expect the German GDP growth to moderate to around 2%, with a net exports contribution about half of that expected for 2010, while the recovery in private consumption will not be enough to offset the moderation of both public consumption and investment due to lower foreign demand.

On consumer prices, inflation accelerated somewhat over Q1, but has remained relatively stable around 1.1% y/y in recent months. Despite the significant rise of industrial inflation in recent months, these inflationary pressures are unlikely to end up passing through to final consumer prices due to a still weak private consumption. Overall, we expect annual inflation to remain broadly stable for the remainder of the year, and

thus annual inflation rate should be at 1.1% for 2010 as a whole, accelerating slightly to 1.3% in 2011. Finally, the recent improvement observed in the labour market is expected to continue in coming months, and thus the unemployment rate is projected at 7.2% in 2010, declining from 7.5% recorded in 2009. All in all, as job losses were not too intense over the crisis, the unemployment rate is not projected to be reduced by much in 2011.

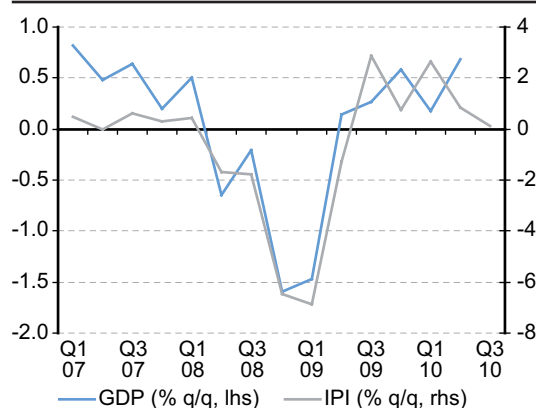
On fiscal policy, Germany also joined the wave of announcements of austerity policies with the intention of becoming an example to the rest of eurozone members, after having stimulated the economy substantially in 2009 and (less prominently) in 2010. The big numbers announced are to reduce government deficit by 10bn per year from 2011 up to 2016 from an expected deficit of 135 bn eur (3.9% of GDP) in 2010. The announced budget cuts more tilted towards expenditure cuts (social benefits), while measures to raise revenues are based on special taxes such as plane fares, eco-taxes and bank levies.

Chart 15
Germany: GDP growth and expectations



Source: Destatis and ZEW institute

Chart 16
France: GDP



Source: INSEE

France: Middle of the pack

The contraction of the French economy during the recession was less intense than that experienced by other member states, having recovered by Q2 nearly half of the accumulated fall during the recession. The French economy also accelerated in Q2, though showing a growth composition that drew a less rosy economic outlook: an anaemic domestic demand when excluding the important contribution of change in inventories, while net exports drained a coupled of tenths to quarterly GDP growth. However, available data for Q3 suggest that economic activity remained resilient. On one hand, consumers' sentiment improved markedly in Q3 influenced by positive news from labour market and low inflation, strengthening their purchasing power. The latter was confirmed by households' consumption in September, bringing Q3 average 1.2% over Q2. Industrial output remained virtually flat in the first two months of Q3 over the previous quarter, confirming the slowdown of industrial recovery, although business confidence suggests that the upswing continued, and thus the modest investment recovery observed in Q2 should hold in coming quarters. On the other hand, the trade balance revealed that exports increased significantly again up to August, although imports also experienced similar growth, suggesting that net exports barely contributed in Q3. For Q4, the flash PMI data for October points to a less optimistic outlook, but clearly remaining in expansionary territory. However, the recent strikes could adversely affect economic activity in the last quarter of the year, though taking into account similar past episodes in France, they should not detract much more than 0.1pp from quarterly economic growth.

Overall, French GDP is projected to grow by 1.6% in 2010, at the same rate expected for the eurozone as a whole. Both private and public consumption should be the main drivers of economic growth for 2010, as the former will continue to be resilient for the second half of the year, while the latter should continue to support economic activity as fiscal adjustment will start only next year. In contrast, investment is likely to fall on average in 2010, despite the modest recovery projected for the remainder of the year. As a result, domestic demand should contribute with 1.3pp to annual GDP growth, supported by a not negligible inventory change contribution, while external demand will only provide a moderate support. For 2011, we expect GDP growth to slow somewhat to 1.4%, as the investment recovery and a relatively stable private consumption growth will not be enough to offset the lower public spending contribution resulting from fiscal retrenchment, along with the depletion of the positive effect of re-stocking. As a result, the domestic demand contribution should decline by 0.1pp, while net exports one will also be 0.1pp lower due to a larger moderation in export growth.

Inflation accelerated rapidly over the first quarter, to stabilize at around 1.8% y/y as from the second quarter, while core inflation remained hovering around 1% since the last quarter of 2009. For the last quarter, we

see inflation remaining stable, and thus the annual average inflation rate should stand at 1.7% for 2010. As domestic demand is projected to weaken slightly in 2011, inflationary pressures are likely to diminish somewhat, resulting on an annual inflation rate of 1.6%. The unemployment rate remained stable at around 9.9% since the last quarter of 2009, increasing slightly to 10.1 in summer. Overall, the moderate economic growth projected is not enough to reduce the unemployment rate that is expected to remain at around 10% in both 2010 and 2011.

On the fiscal front, the government wants to keep up the pace of deficit reduction to achieve 6% in 2011 and 4.6% in 2012, from a 7.7% in 2010. This implies a reduction of the deficit by 104bn euros from 2011 to 2013. The breakdown is as follows: 35 bn will come as the economic activity recovers and receipts return to usual levels, another 15 bn eur as fiscal stimulus are withdrawn and, finally, around 45 bn eur will come from a structural reduction of expenditures. The pension reform has been the most controversial reform leading to social unrest, but will have a small effect on the deficit during the projection period.

Italy: Below average eurozone economic growth

The recovery of the Italian economy has been more hesitant than that of both Germany and France, although after output falling again in the last quarter of 2009, Italian GDP grew by about 0.5% q/q in the first two quarters of 2010 driven by foreign demand. This recovery means that the Italian GDP has recovered only 20% of the cumulative output drop suffered during the crisis, far from German and French performance and slightly better than Spain, which is experiencing the adjustment of the construction sector.

As in most member states, recent short-run indicators suggest a slight moderation in economic growth in Q3. On one hand, the improvement in consumers' confidence, coupled with the resilience of retail sales up until August suggest that private consumption might increase slightly in Q3, after remaining flat in the previous two quarters. Industrial orders rebounded strongly in August, mostly those from abroad, thus showing more evidence on the dependence in external demand developments. In any case, industrial production is likely to continue growing moderately in coming months. However, the latter is unlikely to result in an impact on the investment recovery similar to the one observed in previous quarters, as it has been mainly supported by government incentives that ended in June. The trade balance data up to August suggest another positive contribution of net exports in Q3, due to a sharp slowdown in imports, much higher than that observed in exports.

Overall, GDP is expected to grow by 1.1% in 2010, slowing to 0.8% in 2011, in both cases below average eurozone growth. A sluggish private consumption growth is projected for both 2010 and 2011, while investment will increase slowly in both years, resulting in weak domestic demand, as public consumption will also remain stagnated. Net exports should contribute positively to growth 2010 and 2011. On the labour market, the unemployment rate might have peaked in Q2, falling by 0.4pp to 8.2% in August. Given the weak economic growth projected, the unemployment rate could rise again in coming months. We foresee it at around 8.6% in both 2010 and 2011.

Annual headline inflation has remained broadly stable at around 1.7% since Q2, interrupting the rapid upward trend started by mid-2009 as a consequence of the reversion of the base effect from energy prices. Core inflation has also remained at relatively high levels over 2010 (around 1.5% y/y), in contrast to subdued rates observed in other member states. Looking forward, average annual inflation rate is projected at 1.6% and 1.8% in 2010 and 2011, respectively.

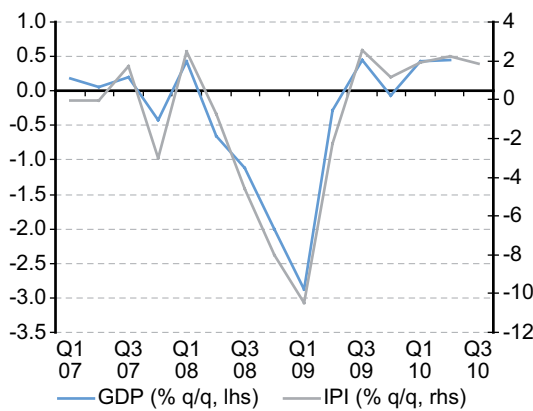
On public accounts, the Italian government projects a -5% deficit in 2010 and plans to reduce it then to -3.9% in 2011 and -2.7% in 2012. Italian austerity measures are designed to save around 24 bn EUR, equally distributed across two fiscal years 2011 and 2012, and more tilted towards expenditure measures. Budget execution up to Q2 remains broadly on track and we expect that it will reach the target this year.

Spain: Anaemic economic growth in H2 2010, growing moderately in 2011

Three months ago, the Spanish economy was facing four sources of uncertainty that were putting a downward bias on growth, namely the continuing uncertainty and volatility in financial markets, the expected weakening of exports due to the depletion of the fiscal impulse in Europe, the expected acceleration of fiscal consolidation in Spain starting 2Q10 and, finally, the weakness of private domestic demand due to the on going adjustment of imbalances accumulated before the start of the crisis.

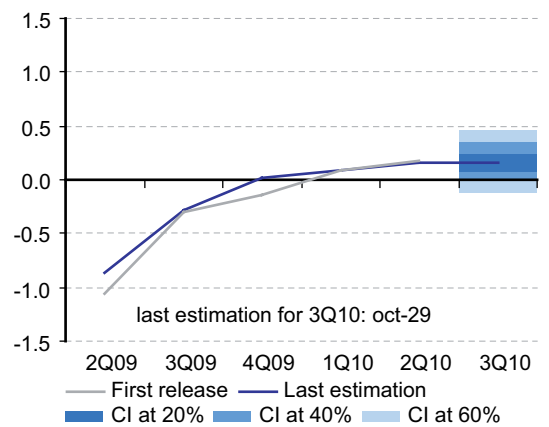
Nonetheless, recent developments like the positive differentiation of Spanish financial assets, better than expected performance of exports, a stronger domestic demand than originally estimated and the advances on the structural reform front have produced a change in expectations more towards stagnation than towards a fall in output. Looking forward, economic activity should still be close to anaemic, as domestic demand will struggle to maintain the pace of the recovery seen in H1 10. Therefore, we are forecasting that the economy will return to positive growth in 2011 but that it will still be very weak and not strong enough to generate jobs. In this environment, core inflation will remain subdued. For details on the projections, see Spain Economic Outlook, November 2010.

Chart 17
Italy: GDP



Source: ISTAT

Chart 18
Spain: GDP Growth and Estimate Based on the MICA-BBVA Model (% q/q)



Source: Eurostat and BBVA Research

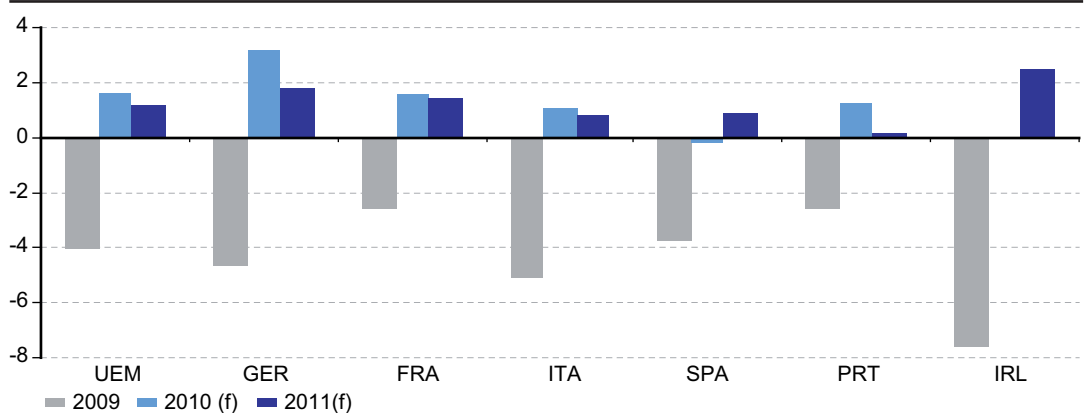
Growth prospects in Greece, Portugal and Ireland show signs of stabilization, but the recovery will be weaker than in the core countries

Given fiscal tightening measures, the **Greek** economy should hang further in Q3, after having slumped in Q2, with private consumption falling heavily in that quarter but offset by net exports. This is in line with an expected average decline of -4% y/y for 2010 and -2.6% in 2011 (as estimated by the IMF-EC plan for Greece). On a positive note, structural reforms are on track and in some cases ahead of schedule, as in the case of the pension reform.

Portuguese economic activity slowed down in Q2 after the sharp increase in Q1. Private consumption increased moderately in Q2, while investment declined again and net exports contributed negatively to growth (-0.7pp). and most short term indicators point to a clear deceleration for Q3. We forecast an increase of 1.3% in 2010 and deceleration of 0.2% in 2011, mostly due to the impact of fiscal adjustment.

The **Irish** GDP growth for Q2 was -1.2% q/q, with a sharp negative contribution of the external sector (-1.8pp). Exports growth decelerated considerably down to 1.6% q/q, partly compensating a previous 7.1% q/q in Q1, while imports kept growing at 4.5% q/q. Recent indicators suggest that the economic outlook is heading downwards over H2 2010, so Irish economic growth could be flat on average in 2010 but then recover in 2011.

Chart 19
GDP growth by countries (% Annual GDP Growth)



Source: BBVA Research

Box: United Kingdom

Activity shows signs of strength

Economic activity in the UK continued to surprise upwards in Q3 with a growth rate of 0.8% q/q, after a very strong 1.2% q/q in Q2. The outcome of Q3 was due to an important contribution from the service sector and a significant recovery of construction. Although we had projected a slowdown in Q3, higher frequency data was recently signalling that economic activity was weakening, but only at a slow pace. The detailed demand side breakdown for Q2 showed a rather disappointing growth composition, with a weak domestic demand contribution when excluding the change in inventories and without a clear improvement in exports, as observed in other European countries (and despite the expected delayed effects from the exchange rate depreciation).

All in all, we expect an average GDP growth of 1.5% for 2010 and 1.7% for 2011. Private demand will be subdued in 2010 on average and gain momentum in 2011 as labour markets recover and households slow down their process of de-leveraging. Public demand, which in spite of the recently announced austerity measures will continue to post positive increases this year, will weaken markedly in 2011. Investment is expected to increase as corporates are beginning to draw on their strong financial position.

The labour market still shows mixed signs. Unemployment rates fell by 0.1 pp in August to 7.7%, after 14 months slightly above 7.8%, while employment showed signs of recovery mainly from the private sector (though mostly for short-term jobs). On the other hand, the number of jobless claimants continues to increase.

In spite of the depreciation of the pound by approximately 20% against the EUR and the USD since 2007, the external

sector remained sluggish as main export destinations (continental Europe and the US) have just exited from the crisis. Nevertheless, we expect positive contributions from the external sector from 2011 onwards.

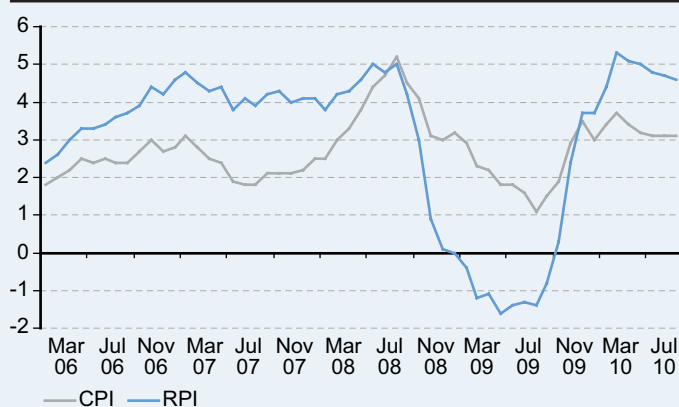
Inflation remains above target and the Bank of England is facing a policy dilemma

Inflation is persistently above target and this deviation can be explained by the increase in VAT, higher energy costs and higher imported input prices. Further tax increases will take place at the beginning of 2011, with an increase in VAT from 17.5% to 20% by January 2011. Price developments kept surprising upwards this year. In January expectations were of around 2.4% average inflation for 2010 and now inflation is expected to end at around 3.1%, and for next year to fall to about 2.8%.

This mix of high inflation and economic developments has kept divided the MPC members with regard monetary policy actions. The majority advocates to keep both interest rates and asset purchases unchanged, while Adam Posen is pushing for an increase in the purchase programme by additional 50 bn GBP, while Andrew Sentance advocates for 25 bp increase of the interest rate. The large output gap and the fact that the US is expected to embark in QE2, together with dovish declarations by Governor Mervyn King raise also the possibility that the BoE will embark into further easing. However, the positive surprises on activity and the resistance of inflation to converge to the target make us think that the BoE will not embark on QE2 before the US and an eventual loosening will depend on further developments. Still, with regard to interest rates, we do not expect any hike from the current 0.5% for 2011 and well into 2012.

Chart 20

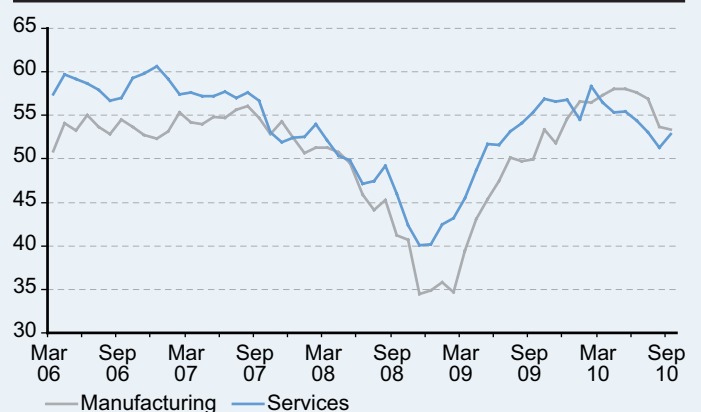
United Kingdom: Price indexes (% y/y)



Source: ONS and BBVA Research

Chart 21

United Kingdom: PMI Markit



Source: Markit and BBVA Research

Tough austerity measures ahead

By mid-October the Government announced its Spending Review, following the emergency budget announced on June 22 shortly after the Conservative-LibDem government was formed. Government spending will be reduced by 83bn GBP and tax changes will rise 29 bn GBP in four years, so as to achieve the target of reducing the general government deficit from a 11.3% expected for the fiscal year 2009-10 to a 2.2% by 2014-15. For the current fiscal year 2010-11, the government projects a mild reduction to reach a 10.8% of GDP, but for the following fiscal year the target is 7.6%. Revenue increasing measures were announced in June, and include, among the most relevant, a VAT increase by 2.5 pp up to 20% starting on January 2011, a rise in the capital gains tax from 18% to 28%, and a bank levy initially

set at 0.04% that is expected to raise 2bn GBP revenues. At the same time, some taxes were reduced with the aim of promoting investment and employment, such as corporate taxes by 4 pp (from 28% to 24%) in 4 years, while the tax ceiling on personal income was raised for lowest incomes to compensate for the ending of a complex system of tax allowances and deductions. In the recently disclosure of the Spending Review spending cuts were detailed for each Ministry, with an average reduction of 19% including the cut of 500.000 public sector jobs through to 2014 and the increase in retirement age, up to 66 by 2020 and to 68 by 2038. This raise was under review before the summer, though the news is that it will be effective earlier than expected.

5. Monetary policy: ECB to remain on hold as the Fed expands further

US Fed loosening will influence the course of action of other central banks

The US economy has slowed to a below-trend growth pace in 2H10 and the Fed sounds increasingly concerned about the economic outlook and worried about deflationary pressures. Recent communication has set the groundwork for further monetary easing by clearly stating that current economic conditions are inconsistent with Fed's dual mandate of full employment and price stability. The last FOMC Minutes (October 12th) built the case for QE2 and Bernanke's speech on October 15th went further by making explicit the Fed's objective for inflation and unemployment and stating that inflation is too low while unemployment is too high. The Fed's view is that almost all of the recent rise is cyclical unemployment and thus, should be addressed by monetary policy. Bernanke concluded that "the short term real interest rate is too high".

But with nominal interest rates already quite low, the Fed will try to reduce the term premium in the yield curve to prompt investors to shift to other assets, helping avoid the liquidity trap. In the next FOMC meeting on November 3rd, the Fed will continue to implement unconventional monetary easing policies, primarily through balance sheet expansion (QE2). It is likely that the Fed will announce a final target number, but with lenient conditions attached related to financial stability or the macroeconomic outlook. In our estimation, this target number is likely to be around \$1tr. Our estimate is that initially monthly goals will be close to \$65bn.

Possibly, as the Fed moves toward a new round of ease (QE2) other central banks will be strained to adjust their monetary policy stances. In the current global economic context with a shortage of demand, countries will likely be forced to follow Fed's actions in order to prevent unwanted currency appreciation. QE2 from the Fed would likely prompt adjustments for monetary policy in other countries.

The ECB response will be influenced by the exchange rate

Currently the European Central Bank (ECB) has a more hawkish stance and seems opposed to further easing. The ECB has had a different communication strategy and has not yet revealed the internal debate that exists in monetary policy. We consider that the ECB should not remain indifferent to recent euro's strength as it could damage the eurozone growth. Over the last five years, the euro has averaged 1.34 vs. the USD, which considering our estimated equilibrium exchange rate¹, implies a persistent overvaluation of about 20%. Prolonged currency misalignments such as this have not been sustainable over time. Going forward, the ECB is expected to start making some wording changes. Other options could also be considered.

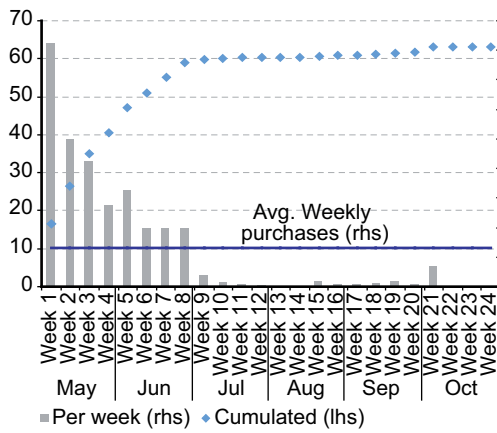
Over the last quarter, the ECB stance has been very cautious. In the two council meetings since our last publication the most important change was in the September meeting when the ECB extended the liquidity provision to the financial system with the full allotment tender operations "for as long as necessary and at least until January 2011". Regarding the Securities Market Program over the last quarter the amount of bonds bought by the central bank on average has been very small. Although in the last three months the ECB only increased its bond purchases once (coinciding with the pick up in sovereign risk associated with Irish banking sector), it proves that the ECB remains committed to do whatever is necessary to help the normalization of financial markets.

The ECB will not implement quantitative easing measures, even though the Fed is accelerating its QE2 and the financial stress in Europe is still a source of concern, but we do expect that the ECB will consider other options such as an extension of the full allotment beyond the first quarter of 2011. The ECB reaction in the coming months will be determined by the balance of risks between the economic and inflation outlook and the financial market performance. As macroeconomic outlook is not expected to exert any significant pressure on monetary policy, the ECB mode should be clearly focused on preventing further episodes of high financial stress and, although less likely, to avoid an excessive appreciation of the euro that could arise from the quantitative easing implemented by other central banks. Overall, given these considerations, the inflationary outlook, and the moderate pace of the activity, we expect that the ECB will keep the interest rates unchanged at 1% for the foreseeable future.

1: PPP and productivity adjusted.

Chart 22

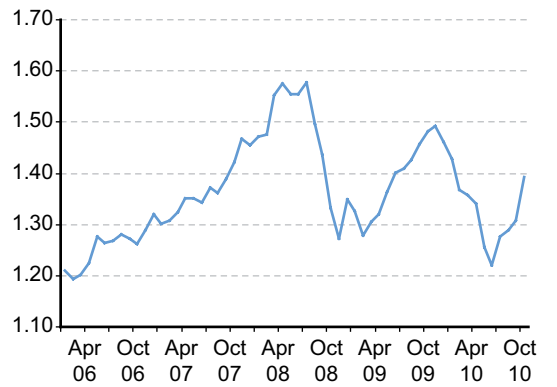
ECB: Sovereign bond purchase program



Source: ECB

Chart 23

USD/EUR exchange rate



Source: Bloomberg

6. Periphery under stress

Risks remain high

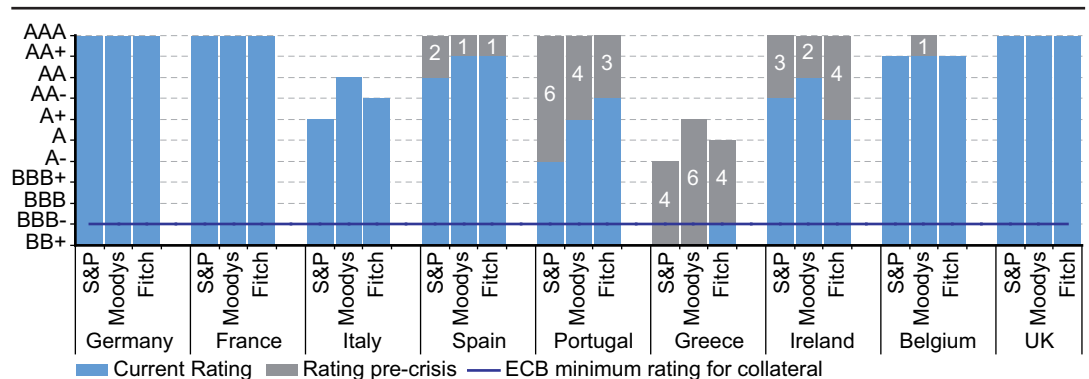
Since May eurozone peripheral economies have been under particular stress due to concerns about its economic recovery and the magnitude of different macroeconomic imbalances accumulated in recent years and during the crisis. Concerns mounted on their ability to correct for such imbalances as large fiscal deficits, subsequent large public debt ratios, large current account deficits and housing bubbles. Markets also worried on the capacity of these countries to grow, due in some cases to weak structural conditions but also to high financing costs and the potential impact on activity of fiscal consolidation plans.

Markets jitters can be seen in the level of sovereign spreads, which have returned to high marks for Portugal, Greece and Ireland with the extension of banking problems in Ireland during August. They have also been reflected in ratings by credit agencies since the beginning of this year, which have reduced by several notches while there are still fears of further downgrades (Chart 24). It is worth noting that there has been a differentiation effect before and after stress tests published in July. Countries such as Italy and Spain have reduced their differentials with respect to the German bund, while Greece, Portugal and Ireland maintained differentials at high levels.

In this section we review those structural elements that lie behind the sovereign crisis. In principle, interest rate differentials reflect the likelihood of default of sovereign bonds. Behind these, there are considerations not only on public deficit and debt levels, but also on growth potential and factors related to private debt, such as external imbalances (current account deficits and external debt) and banking sector problems, which could all lead to public intervention and therefore weaken also the position of sovereign bonds.

Chart 24

Eurozone: Sovereign ratings: in # number of notches down since start of the crisis and outlook



Source: Bloomberg and BBVA Research

Plans to reduce public deficit levels are rapid enough, but public debt stabilizes at very different ratios in some countries

Fiscal deficits deteriorated rapidly in 2009 due in part to fiscal stimulus measures so as to counteract the negative effects of the crisis, but mostly to the deterioration of the structural budgets. Fiscal revenues fell sharply in those economies, such as Spain and Ireland, with bubbles in their housing markets and rapid consumption growth. In Greece, a large hidden deficit emerged, while Portugal started already from a weak structural position. In other eurozone countries deficits grew considerably but to lower levels (Chart 25).

Consolidation plans started to be approved already at the beginning of the year, but accelerated in May as market pressure mounted on peripheral countries. Spain and Portugal presented additional measures of consolidation in May, while Greece had planned a sharp adjustment for early 2010.

The implementation of austerity measures is expected to be reflected already in this year. Budget executions up to now are in line with targets, except for Portugal, where they are behind although the government has taken additional measures by announcing the transfer of the Portugal Telecom pension fund (1.5% of GDP) that will help to solve this year budget. Fiscal data up to September

from Greece, Ireland and Belgium show that budget execution figures are broadly in line with plans. Although in the case of Greece there are some concerns about local entities, while the final figures for 2009 are also under scrutiny by Eurostat, which is expected to revise the deficit for that year from a 13.6% of GDP to around 15% due to reporting problems in social security funds, public entities and off-market swaps. An official confirmation is expected by mid-November. In Ireland, the cost of the banking crisis will raise the deficit for this year to 32% (Chart 25 only shows the deficit excluding this extra cost).

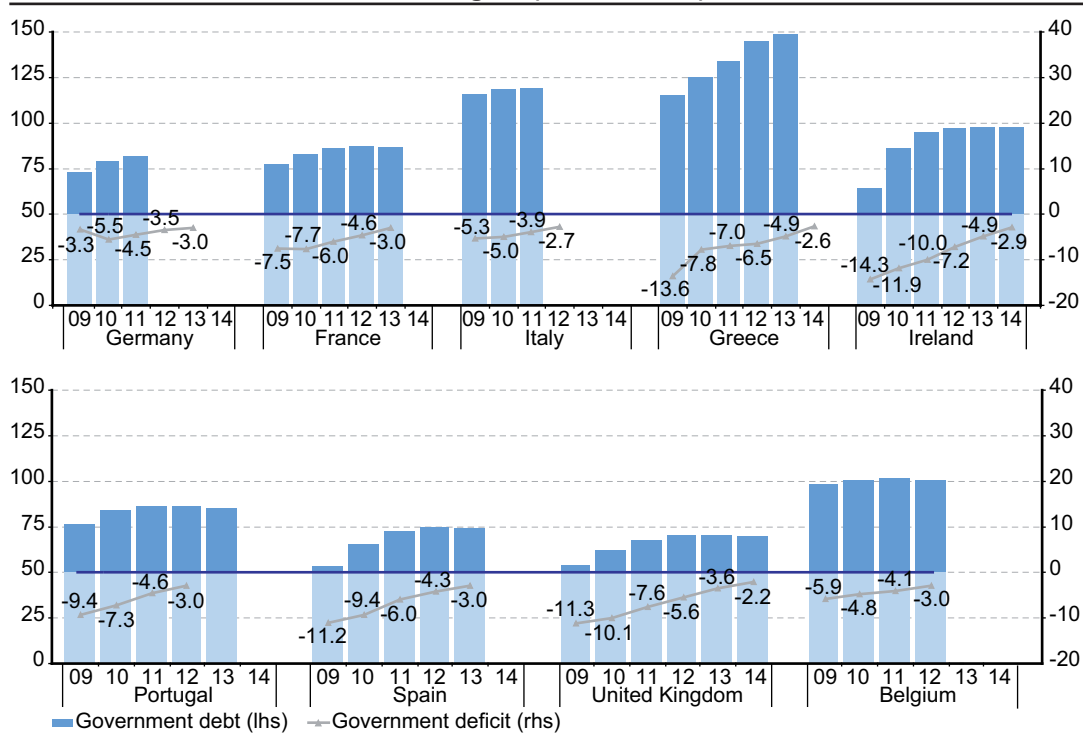
The next step, and source of risk, is the approval of budget drafts for 2011 by the respective parliaments. **Spain** passed the budget bill with measures enough to fulfil the stability plan target of 6% in 2011, but in Portugal the approval is still subject to political hurdles. **Greece** officially presented the budget in early October. It is slightly more ambitious than the one agreed with the IMF, but still needs to be examined by the parliament. **Ireland** will shortly unveil the details of fresh austerity measures with the aim to achieve the 3% deficit target in 2014 as cyclical and bank related problems in 2010 have absorbed previous tightening measures.

Banking troubles can also add to mistrust in sovereign bonds to the extent that large prospective losses have to be paid in the end through public aid. This is the case of Ireland, whose banking system is facing considerable solvency issues stemming from the bursting of the real estate bubble and poor crisis management. It has increased haircuts applied in its programme of bank's asset purchases by the State (NAMA) several times. Irish public aid could reach up to 43 billion euros, or 30% of GDP, according to the Irish government's base case scenario and problems are concentrated in the country's main institutions (not included in debt calculations of chart 25).

Meanwhile, banking problems in other peripheral countries are much smaller and will not likely add to sovereign financial risk. Portugal's financial system is suffering from liquidity problems, reflected in the fact that its recourse to the ECB for liquidity continues to grow and amounts now to an equivalent to nearly 9% of its assets. In Greece, as economic activity deteriorates and credit agencies have downgraded sovereign debt, banks are also facing a liquidity pressure, which has resulted in recourse to ECB financing. However, problems in Greek banks are thought to be a consequence of the crisis, rather than a cause, as they were relatively conservative before the crisis despite their operations in several South East European countries.

Chart 25

Eurozone: Fiscal deficit and debt targets (as % of GDP)



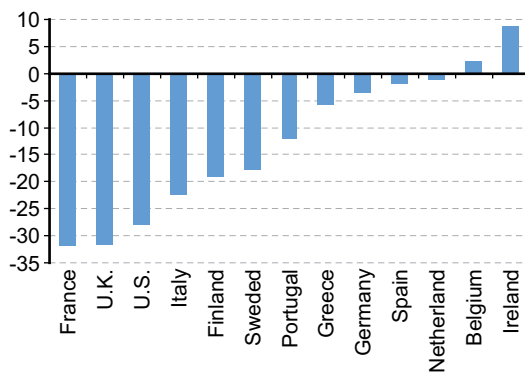
UK: figures according to Maastricht definition
Source: National Governments and European Commission

External deficits still high in Greece and Portugal, and difficult to adjust

Current account deficits recorded levels before the start of the crisis above or close to 10% of GDP in Spain, Portugal and Greece (Chart 27). Since then and due in part to the drop in domestic demand, deficits have adjusted, but much more in Spain than in the other two countries. Spanish deficit is currently at 4.8% while Greece and Portugal remain above 10%. Large and persistent current account deficits are often associated with competitiveness problems, but in these countries, despite the increase of unit labour costs during the past decade there has not been a large loss of export shares in world trade (Chart 26). Rather, the slower adjustment in Portugal and Greece as compared to Spain (and Ireland) reflects the underlying causes of that deficit. The Spanish current account deficit was produced through a sharp increase of investment (construction and other) during the boom years, which is being rapidly absorbed, while savings remain broadly unchanged. In contrast, Greece and Portugal have a much larger share of consumption over GDP (Chart 28) and their growth was based in recent years more on consumption than on investment, and therefore (due to the resilience of consumption during crisis) the adjustment is much more difficult to achieve.

Chart 26

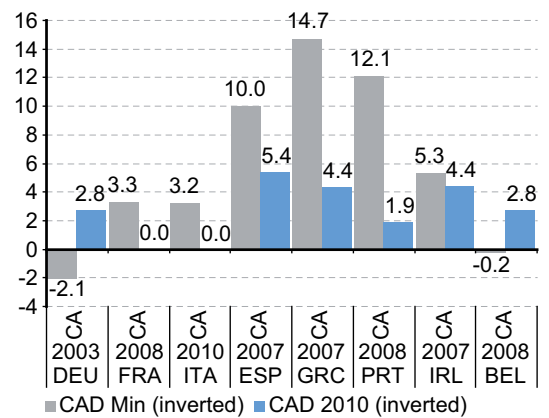
Share in world total exports. Merchandise trade and market services. Rate of change 1999-2009 (pp)



Source: Eurostat and BBVA Research

Chart 27

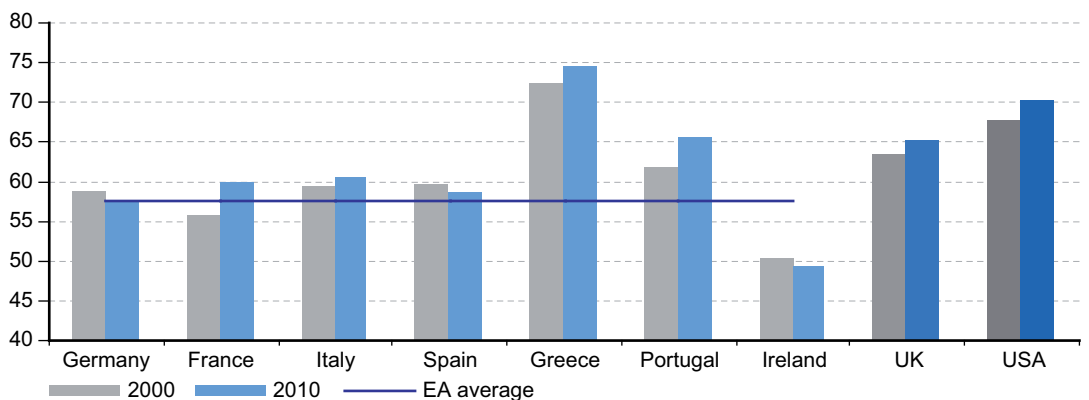
Current account



Source: Eurostat and BBVA Research

Chart 28

Private consumption (as % of GDP)



Source: Eurostat and BBVA Research

Tables

Summary of forecasts

Table 1

Eurozone (YoY)

	2007	2008	2009	2010	2011
GDP at constant prices	2.9	0.3	-4.0	1.6	1.2
Private consumption	1.7	0.4	-1.1	0.7	1.1
Public consumption	2.2	2.4	2.4	0.9	0.4
Gross Fixed Capital Formation	4.6	-1.0	-11.3	-1.3	1.0
Inventories (*)	0.2	-0.2	-0.7	1.3	0.1
Domestic Demand (*)	2.6	0.3	-3.3	1.6	1.0
Exports (goods and services)	6.3	0.7	-13.1	9.1	4.4
Imports (goods and services)	5.8	0.6	-11.8	9.2	4.0
External Demand (*)	0.3	0.0	-0.8	0.0	0.2
Prices and Costs					
CPI	2.1	3.3	0.3	1.6	1.7
CPI Core	2.0	2.4	1.3	1.0	1.3
Labour Market					
Employment	2.0	1.0	-1.8	-0.5	0.2
Unemployment rate (% of labour force)	7.5	7.6	9.4	10.1	10.2
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-0.6	-2.0	-6.3	-6.2	-5.1
External Sector					
Current Account Balance (% GDP)	0.1	-0.9	-0.6	-0.5	-0.2

* Contribution to growth
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.1	0.4	-2.6	2.7	2.3
EMU	2.9	0.3	-4.0	1.6	1.2
UK	2.6	-0.1	-4.9	1.7	1.9
Latin America *	5.8	4.0	-2.4	5.8	4.2
Asia	7.6	4.2	2.0	6.8	5.5
China	14.2	9.6	9.1	10.1	9.2
Asia (exc. China)	5.2	2.1	-0.7	5.6	4.1
World	5.3	3.0	-0.6	4.7	4.1

Forecast closing date: 29th October 2010

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.9	3.8	-0.3	1.6	1.2
EMU	2.1	3.3	0.3	1.6	1.7
UK	2.3	3.6	2.2	3.1	2.8
Latin America *	5.3	7.7	6.4	6.5	6.3
Asia	2.9	5.1	0.3	2.8	2.8
China	4.8	5.9	-0.7	3.0	3.3
Asia (exc. China)	2.2	4.8	0.7	2.8	2.6
World	4.1	6.1	2.2	3.6	3.5

Forecast closing date: 29th October 2010

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela

Source: BBVA Research

Table 4

Macroeconomic Forecasts: Current Account (% GDP)

	2007	2008	2009	2010	2011
United States	-5.2	-4.9	-3.0	-3.7	-3.9
EMU	0.1	-0.9	-0.6	-0.5	-0.2
UK	-2.7	-1.3	-1.1	-1.6	-1.3
Latin America *	0.7	-0.5	-0.3	-0.7	-1.3
Asia	5.6	4.1	3.6	3.5	3.5
China	10.9	9.6	6.0	5.6	5.1
Asia (exc. China)	3.6	2.1	2.7	2.7	2.9

Forecast closing date: 29th October 2010

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela

Source: BBVA Research

Table 5

Macroeconomic Forecasts: Government Deficit (% GDP)

	2007	2008	2009	2010	2011
United States	-1.2	-3.2	-9.9	-10.7	-8.5
EMU	-0.6	-2.0	-6.3	-6.2	-5.1
UK	-2.8	-4.9	-11.5	-9.9	-8.2
Latin America *	-0.7	-1.0	-3.0	-2.2	-2.0
Asia	-0.3	-2.4	-5.2	-5.4	-4.7
China	2.2	-0.4	-2.2	-2.9	-1.9
Asia (exc. China)	-1.3	-3.8	-6.3	-6.4	-5.7

Forecast closing date: 29th October 2010

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela

Source: BBVA Research

Table 4

Financial variables

Official Interest Rates (End period)	2007	2008	2009	2010	2011
United States	4.3	0.6	0.3	0.3	0.3
EMU	4.0	2.5	1.0	1.0	1.0
China	7.5	5.3	5.3	5.6	6.1
10-year Interest Rates (Avg).					
United States	4.6	3.6	3.2	3.0	2.4
EMU	4.2	4.0	3.3	2.7	2.4
Exchange Rates (US Dollar per national currency)					
United States (EUR per USD)	0.7	0.7	0.7	0.8	0.8
EMU	1.4	1.5	1.4	1.3	1.3
UK	2.0	1.8	1.6	1.6	1.6
China	7.6	6.9	6.8	6.5	6.3

Forecast closing date: 31st July 2010
Source: BBVA Research

Germany

Table 5

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	-0.2	0.6	-0.1	0.0	0.9
Public consumption	1.6	2.3	2.9	2.3	0.7
Gross Fixed Capital Formation	4.9	1.8	-10.0	5.3	2.8
Inventories (*)	0.0	-0.2	0.1	0.5	0.0
Domestic Demand (*)	1.2	0.9	-1.5	2.0	1.2
Export	7.9	2.0	-14.3	13.6	5.5
Import	5.2	2.9	-9.4	12.3	4.8
Net export (*)	1.6	-0.2	-3.2	1.1	0.6
GDP	2.8	0.7	-4.7	3.2	1.8
Inflation	2.3	2.8	0.2	1.1	1.3

(*) Contribution to growth
Source: BBVA Research

France

Table 6

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	2.5	0.5	0.6	1.4	1.2
Public consumption	1.5	1.6	2.8	1.5	0.6
Gross Fixed Capital Formation	5.9	0.3	-7.0	-2.0	2.2
Inventories (*)	0.0	0.3	-1.9	0.4	0.0
Domestic Demand (*)	3.4	0.4	-2.4	1.3	1.2
Export	2.5	-0.8	-12.2	8.3	4.1
Import	5.7	0.3	-10.6	6.5	3.0
Net export (*)	-1.0	-0.3	-0.2	0.3	0.2
GDP	2.3	0.1	-2.5	1.6	1.4
Inflation	1.6	3.2	0.1	1.7	1.6

(*) Contribution to growth
Source: BBVA Research

Italy

Table 7

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	1.1	-0.8	-1.8	0.6	0.7
Public consumption	0.9	0.8	0.6	0.1	0.0
Gross Fixed Capital Formation	1.3	-4.0	-12.2	1.4	1.6
Inventories (*)	0.1	-0.3	-0.4	0.4	0.0
Domestic Demand (*)	1.2	-1.4	-3.8	1.0	0.7
Export	3.9	-3.9	-19.1	7.1	3.7
Import	3.3	-4.3	-14.6	6.0	3.0
Net export (*)	0.2	0.1	-1.2	0.2	0.1
GDP	1.4	-1.3	-5.1	1.1	0.8
Inflation	2.0	3.5	0.8	1.6	1.8

(*) Contribution to growth
Source: BBVA Research

Portugal

Table 8

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	2.5	1.8	-1.0	2.0	0.1
Public consumption	0.5	0.8	2.9	2.3	-1.7
Gross Fixed Capital Formation	2.6	-1.8	-11.9	-4.5	-3.0
Inventories (*)	-0.1	0.3	-0.6	-0.1	0.1
Domestic Demand (*)	2.2	1.3	-3.3	0.9	-0.8
Export	7.6	-0.3	-11.8	8.4	5.3
Import	5.5	2.8	-10.9	5.4	1.8
Net export (*)	0.2	-1.2	0.7	0.4	1.0
GDP	2.4	0.0	-2.6	1.3	0.2
Inflation	2.4	2.7	-0.9	1.0	1.1

(*) Contribution to growth
Source: BBVA Research

Spain

Table 9

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	3.7	-0.6	-4.3	1.6	1.0
Public consumption	5.5	5.8	3.2	0.2	-0.5
Gross Fixed Capital Formation	4.5	-4.8	-16.0	-7.2	-1.8
Equipment and other products	6.4	-3.0	-21.2	-2.4	2.3
Construction	3.2	-5.9	-11.9	-10.5	-4.6
Housing	2.5	-10.7	-24.5	-16.6	-6.5
Other construction	4.0	-0.8	-0.1	-6.2	-3.3
Inventories (*)	-0.1	0.1	0.0	0.0	0.0
Domestic Demand (*)	4.4	-0.6	-6.4	-0.7	0.0
Export	6.7	-1.1	-11.6	9.3	7.3
Import	8.0	-5.3	-17.8	6.2	3.2
Net export (*)	-0.8	1.5	2.7	0.6	0.9
GDP	3.6	0.9	-3.7	-0.2	0.9
Inflation	2.8	4.1	-0.3	1.8	1.7

(*) Contribution to growth
Source: BBVA Research

United Kingdom

Table 10

GDP growth and inflation forecasts

YoY rate	2007	2008	2009	2010	2011
Private consumption	2.2	0.4	-3.3	1.1	1.8
Public consumption	1.3	1.8	1.0	1.8	-1.5
Gross Fixed Capital Formation	7.8	-5.0	-15.0	2.2	4.0
Inventories (*)	0.1	-0.5	-1.1	1.1	0.1
Domestic Demand (*)	3.2	-0.7	-5.7	2.6	1.5
Export	-2.6	1.0	-10.6	5.1	6.9
Import	-0.8	-1.2	-12.4	7.7	5.1
Net export (*)	-0.5	0.7	0.8	-0.8	0.3
GDP	2.7	-0.1	-4.9	1.7	1.9
Inflation	2.3	3.6	2.2	3.1	2.8

(*) Contribution to growth
Source: BBVA Research

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This report has been produced by the Spanish and European Unit

Chief Economist

Rafael Doménech
+34 91 537 36 72
r.domenech@grupobbva.com

Europe

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

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

Elvira Prades
+34 91 537 79 36
elvira.prades@grupobbva.com

Economic Scenarios

Juan Ruiz
+34 91 374 58 87
juan.ruiz@grupobbva.com

Financial Scenarios

Sonsoles Castillo
+34 91 374 44 32
s.castillo@grupobbva.com

BBVA Research

Group Chief Economist

José Luis Escrivá

Chief Economists & Chief Strategists:

Regulatory Affairs, Financial and Economic Scenarios:

Mayte Ledo
teresa.ledo@grupobbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com

Financial Systems
Ana Rubio
arubiog@grupobbva.com

Economic Scenarios
Juan Ruiz
juan.ruiz@grupobbva.com

Regulatory Affairs
María Abascal
maria.abascal@grupobbva.com

Spain and Europe:

Rafael Doménech
r.domenech@grupobbva.com

Spain
Miguel Cardoso
miguel.cardoso@grupobbva.com

Europe
Miguel Jiménez
mjimenezg@grupobbva.com

Emerging Markets:

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

Cross-Country *Emerging Markets* Analysis
Daniel Navia
daniel.navia@grupobbva.com

Pensions
David Tuesta
david.tuesta@grupobbva.com

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

South America
Joaquín Vial
jvial@bbvaprovida.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com.co

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Market & Client Strategy:

Antonio Pulido
ant.pulido@grupobbva.com

Equity and Credit
Ana Munera
ana.munera@grupobbva.com

Interest Rates, Currencies and
Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Asset Management
Henrik Lumholdt
henrik.lumholdt@grupobbva.com

United States and Mexico:

Jorge Sicilia
j.sicilia@bbva.bancomer.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macro Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Contact details

BBVA Research

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