RESEARCH

Economic Outlook

Europe

Third Quarter 2012
Economic Analysis

- **Financial tensions intensified** during the second quarter and the eurozone slips back into recession.
- **It is urgent that european authorities accelerate the fiscal and banking union plans,** and that they intervene to reduce the tensions in the short-run.
- **If the foreseen measures of the european summit and by the ECB are implemented,** financing troubles should start to diminish after the summer.
- **The eurozone should grow timidly in 2013,** although the periphery will remain in recession and risks are tilted to the downside.

Index

Closing date: August 3, 2012

Editorial

The eurozone did not have a strong second quarter, as it continued to reel from a deep financial and economic crisis, especially in the peripheral countries, and its macroeconomic indicators continued to deteriorate after an upturn in the first quarter. The eurozone has partially overcome a difficult situation in Greece, where debt restructuring in April was followed by a period of political instability. After two general elections, a coalition government that prefers to see the country remaining in the monetary union and stick with the reform program was voted in. In any case, the situation in Greece remains difficult, given that the country will experience a deep recession this year, and the sustainability of its long-term public debt remains in doubt, despite the restructuring.

Beyond Greece, financial stress worsened in the second quarter, with especially negative consequences for Spain and Italy. The roots of this financial deterioration can be found in the markets' skepticism over the fiscal consolidation and plans to restructure the Spanish financial system, even after the eurozone approved €100bn in recapitalization assistance, and in the widespread perception that the decisions taken thus far by European authorities, despite the progress made, will come up short.

The measures taken at the European summit from 28 to 29 June were positive and necessary steps, although not sufficient to solve the crisis, as they have not had an immediate effect on financial stress. Shared oversight of the banking system, tentatively scheduled to come into force in December, is a first step towards a banking union, although the remaining elements needed for such a union, as well as for fiscal union, will have to be worked out further down the road. Proposals are to be submitted in October and to be approved at the December summit if the eurozone countries reach an agreement.

The summit was more focused on measures for addressing short-term problems. Beyond pro-growth measures consisting mainly of injections of fresh funds—and once shared bank oversight has taken effect—direct bank recapitalization by the European Stabilization Mechanism (ESM), where needed, should help break the link between sovereign and bank debt. The clarification that the European Financial Stability Fund (EFSF) and the ESM may intervene in sovereign debt markets without additional conditionality to the one already established by the Commission in the European Semester is another, albeit small, step for easing sovereign debt tension in countries such as Spain and Italy. In any event such a measure requires these countries to first request assistance and submit a memorandum of understanding with Europe. As it can be seen, these measures are positive, although they will not be applied immediately, and they have not convincingly and definitively allayed the market's apprehension. There is still no buyer-of-last-resort for sovereign debt, a role that the ECB does not play, investors continue to price in exchange-rate risk into their investment decisions within the monetary union, given the possible breakup of the euro, which they view as more likely following the Greek episode and in light of evidence that Europe's strategy of rechanneling imbalances from the periphery will translate into a severe recession in several countries, making adjustments more difficult. Compounding the situation is Germany's delay in approving the ESM and European politicians' statements questioning the validity of the agreements reached at the summit. This creates wariness in the market, which sees high implementation risks in the decisions adopted.

In light of this outlook, it is important that countries continue to follow the roadmap that has been drawn up through reform programs and adjustments, and that the decisions taken in June will be implemented in order to alleviate as quickly as possible the financing problems of sovereign governments and private investors in the periphery. Interventions in sovereign markets could take a variety of forms (purchases on the primary debt market, purchases on the secondary market, guarantees on new debt issuances). The buying capacity of rescue funds could even be enhanced by granting a banking license to the ESM, that would be very effective to alleviate liquidity strains.

In this context, the ECB's last meeting on August 2 cleared several uncertainties regarding the possible resolution of the debt crisis. The ECB signaled that it was likely to resume purchases of bonds, but emphasized that it is a necessary condition that countries ask support from the rescue fund EFSF / ESM so that the fund intervenes in the primary market. The formal request would result in the signature of a memorandum of understanding and although the ECB president, Mario Draghi, announced that it would be subject to strict conditionality, this would not impose additional macroeconomic conditions to the recommendations set out in the framework of the European Semester, as decided at the European summit in late June. Only in this way, the ECB would be ready to resume purchases of short-term bonds in the secondary market. The meeting also presented an orientation of nonstandard measures (although no details were provided, the ECB is going to design the different modalities in the coming weeks), and in doing so sent a strong signal that the ECB will do whatever is necessary to preserve the common currency.

Based on the assumption that the authorities will adopt these lines of action, our forecasts expect risk premiums and liquidity restrictions to gradually decline starting in September, although it will take some time for them to disappear altogether. With less risk of a financial crash, the European economy should manage to emerge from the current recession by the end of the year and see moderate growth next year (0.3%), although it will not avoid a recession this year (-0.3%) owing to the cumulative decline in activity since the fourth quarter of 2011. Non-core countries will remain mired in a deep recession owing to fiscal adjustments and deleveraging by economic agents. Countries in central and northern Europe may experience some growth, although in the second quarter the decline in activity also affected them because of sluggish domestic as well as global demand. Against this backdrop, inflation should fall and reach two percent at the beginning of next year, and the ECB can be expected to keep interest rates at current levels or even lower for a prolonged period.

The roadmap is now becoming more clear, but the implementation risks are evident and stem from the possibility of a financial crash somewhere or in some sector in Europe, with a high probability that contagion will spread to other countries. Nevertheless, not even in this scenario do we believe that a breakup of the euro is possible, given that European authorities have now taken important steps in favor of greater economic integration, and appear eager to intervene decisively should the need arise.

1. Global outlook: a slowdown that may deepen unless decisive economic policy action is taken

Global growth will improve only if key economic policy measures, already approved or still under consideration, are implemented in time

After a weakened global economy in the first part of 2012, the role of economic policies will be crucial to improve growth prospects in 2013. Our global growth scenario described in this publication, at around 3.5% during the 2012-2013 period, depends both on the monitoring and implementation of measures already approved and on the adoption of new measures. These steps are necessary to avoid a financial "accident" in Europe, an automatic fiscal adjustment in the United States (U.S.) and to stimulate growth in emerging economies. However, if economic policies fail to achieve their goals, the current slowdown, in place since 2011, is likely to intensify in 2012 and 2013, leaving global growth next year at its slowest pace in 30 years (except for the 2009 recession).

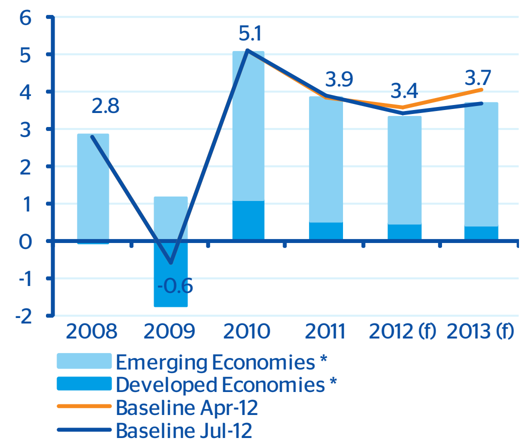
At a summit in June, the eurozone leaders reached agreements in the right direction to reinforce the currency union: single bank supervision in the eurozone, far-reaching plans covering banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms that have been approved to ensure financial stability in the eurozone (i.e., EFSF&ESM) must be used in their full capabilities as soon as possible to avoid a financial "accident."[1] This is the only way to make sure that those economies currently struggling to access financial markets have the chance to implement fiscal-consolidation plans and structural reforms. This should include the involvement of the ECB.

In the US, there must be an agreement to prevent automatic spending-cut measures and the expiration of tax cuts from coming into force at the beginning of 2013. This "fiscal cliff" would not solve long-term sustainability of the country's public finances and, if all measures materialized, they would push the US economy back into recession in 2013. As the presidential campaign makes any kind of agreement difficult until the elections, the surrounding uncertainty over the outcome of this process is likely to play a key role in shaping the economic and financial outlook as we move towards the end of the year.

Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand, so that the effects of the external slowdown are mitigated. Additionally, volatility of capital inflows could increase, due to the ebbs and flows of the eurozone crisis and, on the other hand, flows related to a new round of quantitative easing the US Fed is likely to embark on.

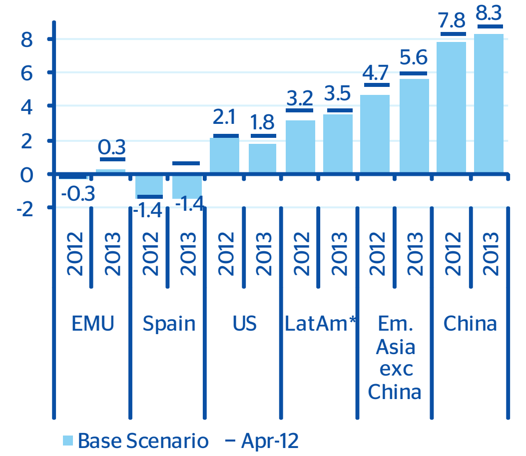
1: The financial "accident" could take various forms, including for example the lack of demand for sovereign-bond issuances of peripheral economies.

Chart 1
Global GDP growth (%)



* Growth contributions
Source: BBVA Research

Chart 2
GDP growth by area (%)



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

Failure to dovetail sovereignty transfer with debt mutualisation at the rhythm that markets demand prolongs the euro crisis

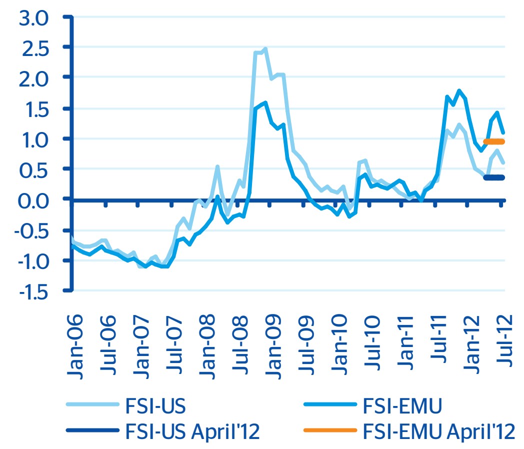
The main uncertainty over the current economic scenario is whether the efforts that the eurozone countries will have to make to reinforce their governance will be preceded by a further deterioration in their financial situation. If this were the case, we think that it would produce massive interventions from EU mechanisms to eventually assure the financial stability of the eurozone. The decisions already taken, if implemented forcefully, could suffice, but that requires that the measures approved at the end of June are implemented quickly. Those measures aimed to eliminate the risk emerging from the sovereign-banking feedback loop in Spain and to stabilise financial markets across the eurozone with the active use of the EFSF and later on of the ESM actively purchasing bonds in the primary and secondary market. Recent policy measures in Spain to reign in the deficit together with the strongly supportive stance by the President of the ECB are helping to ease tensions.

All in all, we have revised downwards our previous forecast (released three months ago) due to continued financial stress stemming from the eurozone crisis and ongoing deterioration in global economic confidence. This scenario implies a period of stagnation in the eurozone in 2012-13. Despite this revision, in our view, the balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly, due to domestic-policy considerations in some countries. If that were to happen, then the risk of a recession in Europe in 2013 would be relevant, especially in countries such as Spain and Italy.

Eurozone countries have to solve the liquidity squeeze on some markets. Those constraints are a consequence of market participants assigning some probability that a euro break-up may occur. Eurozone countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms to reduce imbalances at the rhythm that markets demand. As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the eurozone. A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break up. However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures is lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualisation). That will also happen with fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. If the challenges ahead are met satisfactorily, global growth could gradually gain traction during H2-12.

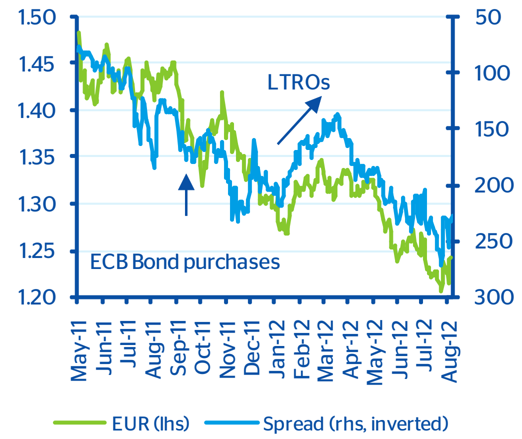
In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in H1-12 and the impact of a high financial stress from the eurozone. As a result, emerging economies are likely to be the main driver behind the slight acceleration in global GDP we expect for 2013. In Latin America, despite a generalised downward revision in growth forecasts compared with three months ago, estimates for Mexico (3.7% and 3.0% for 2012 and 2013, respectively) remain unchanged thanks to upbeat activity data in H1-12, the continuation of favourable financing conditions in the domestic market, and gains in competitiveness. In Brazil, growth forecasts have been significantly revised downwards (to 2.2% from 3.3% in 2012) due to the impact of the external environment and to some domestic issues, such as the slowdown in credit markets and increasing competitiveness problems. Even though activity is still expected to recover in the quarters ahead, following the unprecedented softening of monetary conditions, the recent moderation warns against the current growth model and its excessive focus on private consumption and credit expansion.

Chart 3
Financial stress indicator, BBVA Research (*)



(*) Tracks the trend of a series of financial variables, including: stock market volatility; interest rates and exchange rates; sovereign, credit, and corporate risk; and liquidity tensions
Source: BBVA Research

Chart 4
Dollar-euro exchange rate and Spanish and Italian risk premiums



Source: BBVA Research and EPFR

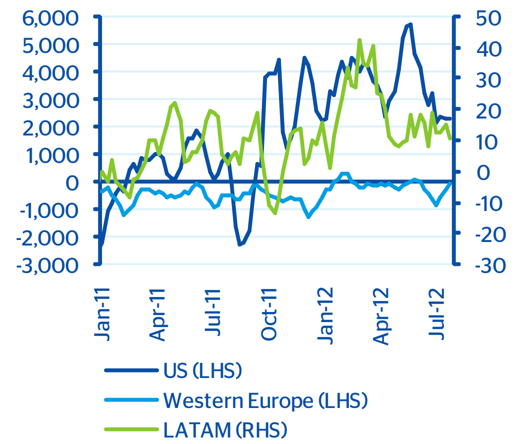
As for Asia, growth in H1-12 slowed in China more than expected. In line with the weaker global outlook, we have accordingly revised our projections for 2012-13 down. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup, with growth in 2013 rising to 8.3%, a 0.5 pp higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. But there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

Abundant liquidity, accumulated imbalances and doubts about the ability of policy makers to resolve the euro crisis are changing the risk perception across assets in developed and emerging markets

The outcome of the current economic problems is highly uncertain, because there are political-economy considerations at stake that may not be consistent with the incentives to fix a supranational crisis. The risk scenario that dominates the forecast horizon (2012-2013) appears to be more focused on the developed economies and in particular, on the eurozone. Emerging economies have more room to manoeuvre than developed economies when it comes to demand policies (fiscal and monetary), and also have, overall, lower accumulated imbalances. As a result, there have been increasing capital flows from Europe into the US and the emerging markets, including those in Latin America.

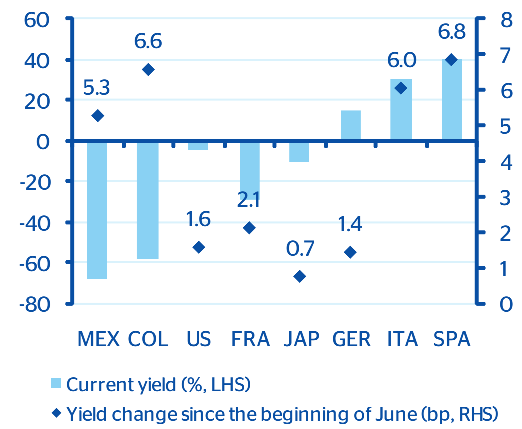
These shifts in financial flows are a reflection of the level of uncertainty and of the fact that risk is focused on developed economies. Both factors have led to a change in the risk characteristics across assets in emerging and developed markets. Since the end of May (when markets started pricing in that the US economy was running out of steam) yields on bonds that are traditionally regarded as risk-free sovereign assets (US and Germany) have fallen to historically low levels. Since the end of June, doubts surrounding the ability to reach a rapid solution to the euro crisis have been pressing towards the same direction. Peripheral sovereign bonds have been perceived as riskier, whereas yields on emerging-market bonds, such as Mexico's and Colombia's, have fallen to all-time lows. Record foreign inflows are searching for returns in economies as isolated from the source of the crisis as possible, with good macroeconomic policies and growth prospects, in countries where any direct channel of contagion is relatively narrow, and where the room for manoeuvre in economic policies is ample.

Chart 5
Sovereign debt flows (USD bln)



Source: BBVA Research and EPFR

Chart 6
Long-term (10Y) bond yields, changes since the beginning of June (bp)



Source: BBVA Research

But there are risks to the sustainability of this scenario. Apart from changes to local inflation or growth outlook that may cause rising yields, global factors, such as systemic shock in the eurozone, could wipe out all the safe-haven value recently gained by certain emerging-market assets, e.g. those in Latin America. In the case of a systemic event, it remains to be seen whether domestic strengths (e.g., lack of fiscal imbalances) would be preserved in the event of a "Lehman-type" shock. In the event of a systemic risk, it is likely that only the assets of economies that have their own currency and a central bank that acts as the lender of last resort, and do not have any significant external imbalances, will be regarded as risk free. On the other hand, additional expansion of the Fed's balance sheet could encourage investors to move out of fixed income and into equity markets, particularly if there are no clear signs of further easing in domestic monetary-policy expectations.

2. European crisis remains unresolved

Now that the risks in Greece have been addressed, the focus is Spain and, by extension, Italy

The elections in Greece in May and June were accompanied by a high degree of financial stress, owing to the risk of a Greek exit from the eurozone, which could have had a knock-on effect on the remaining countries if materialized. Once this obstacle had been overcome, attention turned to Spain as a result of the restructuring of its financial sector and fiscal troubles. Despite the assistance approved by the eurozone to recapitalize part of the Spanish financial system and the fiscal measures adopted by the government, stress remains high and has also been felt in Italy. The European summit in late June adopted constructive measures on bank recapitalization and a possible intervention in the ESM markets, but it has failed to have the intended effect given the implementation risks.

The Greek elections have averted a Greek exit from the eurozone in the short term, but they have introduced exchange-rate risk within the eurozone

The Greek elections in mid-May failed to give a sufficiently large majority to the two parties that had, until then, supported Lucas Papademos' technical government, and hence had to be repeated on 17 June. In the weeks leading up to the elections, financial-market stress intensified given the possibility that a party (or ruling coalition) that did not approve of the essence of the agreements signed by Greece with the troika would win. This was interpreted as there was a high risk that Greece would exit the euro in the near term (even though most Greek parties are in favor of the country remaining in the monetary union). In the end, following the second elections, a ruling coalition was formed by New Democracy, PASOK (the two parties that supported the previous government) and Democratic Left. Together they attained a majority in parliament.

The new government, led by Antonis Samaras, has approved a program centered on privatization and agreed on a further €11.5bn in budget cuts, in compliance with the troika program. In addition, negotiations are pending on a more gradual fiscal adjustment than the one now planned, in order to push back the 3% of GDP deficit target by two years to 2016. Although the likelihood of a Greek exit from the euro has diminished in the short term, risks in the country remain very high given that the downturn is much worse than expected (more than 6% of GDP contraction this year), the deficit targets for this year will not be met, and European authorities are not, in principle, willing to postpone the deadlines for implementing adjustments and reforms.

Market doubts have affected particularly Spain and Italy

The financial stress in recent months has also been related to the situation of large peripheral countries of the eurozone, Italy and Spain. In the case of Italy concerns relate to the problems that high interest rates can bring to an already very high government debt (above 120%) and to doubts about the survival of the National Government that has undertaken recently reforms and adjustments. In the case of Spain the doubts are mostly related to financial system and budget deficit problems. In the latter case, the finding that the deficit in 2011 was much higher than originally planned (approaching 9%), the need of undertaking major adjustment efforts in 2012 and subsequent years, along with the perception of the difficulties to reduce expenditures at the regional level have exacerbated tensions.

As regards the financial system, after the difficulties and the nationalization of Bankia, the EFSF has granted a credit line of up to €100bn to strengthen the solvency of the Spanish financial system, which is a clear step towards the reduction of strains. This aid will take the form of a loan from EFSF to the Fund for Orderly Bank Restructuring (FROB), which will be transferred to ESM when it becomes operational without seniority status, as agreed at the June summit (see below). The ESM will be authorized to directly recapitalize the banks, provided that by then a single European supervisory mechanism is established. Meanwhile, the ultimate responsibility for the repayment of the loan will remain with the Spanish government.

In any case, the difficulties of the peripheral countries remain. The link between the banking and sovereign debt problems joins the vicious cycle that has been produced during the recession, the fiscal problems and the high interest rates on debt, partly induced by the lack of success of the European authorities in the eventual elimination of the risk of a break up of the euro.

The European summit held at the end of June approved measures to support the banking system and intervene in debt markets, but the implementation risks are high

The European summit at the end of June attempted to dispel the financial tension that was dragging down the large countries of the European periphery, Spain and Italy. In the weeks before the summit, implementation of a growth plan to offset the restrictive bias of fiscal policy—already approved at the March summit—and preparations for long-term institutional reforms by the presidents of the European Union, the ECB and the Eurogroup, including a roadmap to fiscal and, especially, banking union, had been openly discussed. Lastly, the summit focused on solutions to short-term financial system debt, leaving most of the institutional topics for the October and December summits.

Specifically, the following agreements were reached at the summit:

- Funds from the permanent rescue mechanism (ESM) may be used to directly recapitalize the banking system, once the unification of the bank supervision system in the eurozone takes effect. The ECB will play a pivotal role in this system. This decision directly affects the Spanish banking system, which will receive funds from the ESM, and these funds will not rank ahead of those of other investors. The eurozone also decided to review the case of Irish banks at the end of the year, triggering a considerable decline in risk premiums on Irish debt. The decisions are important to break the vicious circle between bank and sovereign debt.

- The temporary rescue fund (EFSF) and the ESM, which since the summer 2011 summit have been permitted to intervene in sovereign debt markets, will not require conditionality beyond the conditions laid out in the customary recommendations of the European Economic Semester. Nevertheless, countries requiring intervention must request it and sign a memorandum of understanding with the troika. This measure should make intervention easier, by eliminating the additional conditionality that until now was required in the rules of bailout funds. Italy and Spain benefit the most from this measure (given that the remaining peripheral countries are now outside of the program and momentarily outside of the market in terms of long-term debt), and were the countries that lobbied at the summit in favor of this step.

- A €120bn program was agreed (equivalent to 1.1% of GDP) with the aim to rekindle growth throughout the European Union. The program does not include new funds. Its principal elements are the €10bn recapitalization of the European Investment Bank (creating up to €60bn in additional lending capacity) and a more efficient use of structural funds. This will have a negligible impact on eurozone GDP.

President Van Rompuy has been charged with making headway in designing measures that will lead to fiscal and banking union beyond the decision already taken to proceed to a common supervision system, which should be approved by the end of this year. He is to present his preliminary conclusions in October and his final conclusions in December.

The measures that have been adopted, especially those mentioned in the first two points above, are clearly on the right track and should allow for a progressive easing of financial-market stress. Nevertheless, they appear to have been insufficient, owing to doubts in the markets on various aspects. First, there is no guarantee that the measures will be implemented. Statements by some politicians in Germany and other countries in northern Europe on the time needed for common supervision and therefore for direct recapitalization of distressed banks (for some, this will not be in place even at the end of 2013) are the first element introducing disquiet in the market. Germany's delay in approving the ESM, which should have taken effect at the beginning of July but is awaiting approval by the country's constitutional court in September, adds another element of uncertainty. In addition, the ESM funds (€500bn in addition to the financing already committed) are raising doubts on the capacity to intervene in the markets, especially if another country requires additional bailout funds. Lastly, the deadlines for initiating the institutional-reform processes, which in fact will take years to implement, suggest that solutions consisting of greater long-term integration will not help overcome the short-term problems by improving expectations—especially in light of the lack of details on what this integration process would consist of. At the summit, the topic of Eurobonds was not brought up, not even in its blandest version, the temporary Debt Redemption Fund proposed by the Germans savants, which until recently was at the center of the debate.

In general, the partial nature of the measures adopted and the doubts about applying them, that have arisen very quickly following the summit, continue to reveal tensions between the eurozone's core and its periphery. Discussions on the mutualization of debt—either bank debt (through a deposit-guarantee fund) or sovereign debt (Eurobonds)—are on hold for the time being. Debt-market interventions are limited by the insufficient size of the rescue funds, and proposals to increase those funds or for the ECB to play a direct role run against prejudices about the monetization of public debt and the need to maintain incentives for the reforms prevailing in northern Europe. Meanwhile, in the periphery there is the predominant notion that the adjustments and reforms being applied are already sufficient, and that market dysfunctionality implies a very high cost in terms of financing and scarce liquidity.

Financial tensions have not diminished even after the summit

Against the backdrop described above, financial markets in general and, in particular, the peripheral-debt markets have experienced high volatility. Financial stress has spread to practically every market, without exception. In particular, debt markets have experienced very strong swings, although in opposite directions. Yields have dropped sharply in the core European countries—not only in Germany, but also in the Netherlands, Finland, Austria, France and even Belgium—and in fact have left interest rates at the short ends of the curve in negative territory. The fundamental reason for this movement is the flow of capital to safe haven assets, which intensifies during episodes of volatility in Europe and was recently accelerated by the search for (positive) returns in the wake of the ECB's lowering of the interest rate on the deposit facility to zero.

In the non-core countries, and in particular in Spain and Italy, interest rates have reached their highest levels since the countries in question entered the eurozone, and the spread with Germany has also reached a record level, and in fact is now higher than during the previous crisis episode (late 2011). In recent months, both Spain and Italy have suffered downgrades by some rating agencies, putting them on the verge of losing their investment grade status.

It is also worth mentioning that, the countries receiving bailouts, Ireland and Portugal, have performed relatively better than Spain and Italy, hence, the spread between Portuguese and German bonds has narrowed. This holds even more for Ireland, the bonds of which are in fact located below those of Spain and Italy in some sections of the curve. In addition, Ireland has sold bonds on the market for the first time since its bailout. This performance is clearly related to the dicussions about assistance for the Irish banking system at the European summit at the end of March.

In addition, trading in both the interbank and the primary issuance market has remained quite far from normal operating standards. In the wholesale market, bank issuances dropped sharply in the second quarter of the year. Only a few banks from core European countries took advantage of the window of opportunity created by the ECB's LTRO auctions and by the upbeat sentiment in the markets. There are no signs of a reactivation in the interbank market: even after the cut in the deposit-window rate to zero percent, there are no clear indications that the market is rebounding. Although it is true that less money is being deposited in the deposit window, at the same time the balance position is also increasing (given the lack of distinction between the two now that they offer the same return). Hence, until the interbank market picks back up, the ECB will continue to act as a liquidity broker, which translates into an increase in TARGET2 positions (Box 1). Consequently, the peripheral countries are stepping up their appeals to the ECB, as a reflection of market dysfunction.

The ECB has lowered its marginal rates and is ready to resume bond purchases

The ECB is willing to do whatever is within its means to help solving the debt crisis, as long as governments seek assistance from the rescue funds EFSF / ESM. In this sense, there is the possibility to activate a program of buying bonds more powerful than before and introduce other non-standard measures if necessary.

In its August monthly meeting the ECB signaled that it is likely to resume purchases of bonds, but emphasized that a necessary condition for countries to look to the rescue fund EFSF / ESM is to accept strict conditionality, and then the fund would intervene in the primary market. This conditionality would not imply additional macroeconomic measures, but the signing of a memorandum of understanding between countries and the EFSF to ensure that countries comply with the recommendations within the framework of the European semester. Only in this way, the ECB is ready to resume purchases of short-term bonds in the secondary market. The ECB President Mario Draghi signaled that the purchases will have the right size to meet the goals, and even said it was too early to say whether the potential purchases "are to be sterilized or not," implying that for the moment all available options would be considered, including the possibility for some form of quantitative easing. The meeting also introduced an orientation of nonstandard measures (although without details, the ECB is going to design the different modalities in the coming weeks), among which may be the purchase of private assets or more LTROs. Draghi also noted that the ECB will seek to eliminate the preferred status of the ECB on its holdings of sovereign debt, and sent a strong message on support for the euro. Therefore, after this meeting it became clear that the ECB is willing to do everything within its powers, as long as governments assume increased conditionality.

Regarding conventional monetary policy, the ECB, in its monetary policy meeting in July, lowered the interest rate on refinancing operations (and the window of the deposit and marginal lending facility) by 25bp, placing the refi rate for the first time below 1%, at 0.75%. The ECB's decision was a result of deteriorated cyclical conditions in Europe, where it is perceived that the downside risks, arising from the debt crisis, have begun to materialize. In this context, in which activity is moderating in all economies, including core countries, and inflation risks are balanced, the ECB supports a more accommodative monetary policy. Although not the baseline scenario, further cuts in rates can not be ruled out, if the economy continues to deteriorate stronger and given that the ECB left the door open at its August meeting.

Fiscal adjustments have been strengthened in Italy, France and Spain

In recent weeks, several eurozone economies (France, Italy and Spain) have announced additional fiscal measures in order to meet this year's targets. These adjustments will not, however, entail considerable additional belt-tightening, given that they largely consist of measures needed to meet the deficit targets already submitted by the countries in their stability and growth plans. Since these plans were factored into our forecasts, they do not in general imply a need to modify those forecasts.

Nonetheless, we must acknowledge that the fiscal adjustments implemented in most of the countries run very deep, and that the numbers in question (in terms of primary structural deficit) go far beyond those implemented by most OECD countries in the last 30 years, as noted in our previous publication. Although, given the lack of certainly regarding GDP elasticities to public deficit, the effects of these adjustments on economic activity are uncertain, it is clear that in the present context of financial stress the decline in interest rates that accompanies the "virtuous" reductions in public deficits has not materialized, which translates into higher multipliers. This explains the severe recessions expected for this and next year in most peripheral countries (see Table 1 below).

The euro and the price of oil have slumped, but so has external demand

Over the last 3 months the euro has depreciated by 7% vis-à-vis the dollar, as a consequence of stronger demand for the dollar as a safe haven asset in the wake of the worsening debt crisis the eurozone, the narrowing interest rate spread between Europe and the United States, as well as deteriorating short-term growth perspectives in Europe compared with those for the United States in recent months. In this, as well, the decline in the ECB's deposit-window interest rates to zero percent has had a very significant effect in terms of less appetite for euro-denominated assets. The weaker euro may marginally boost economic activity for a somewhat longer than expected period and trigger certain inflation risks. Nevertheless, in the current European context this risk will be minimal.

Oil prices have tapered off in recent months, as a result of a relaxing of geopolitical tension and lower global demand, and this may have a small positive effect on the economy. This effect will, however, be offset by the slight decline in global activity seen in recent months (see part 1).

Table 1
BBVA Eurozone Budget monitor

		2010	2011	2012	2013	Comments
Germany						
Government Deficit Target	% of GDP	-4.3	-1.0	-1.0	-0.5	Given the better than expected performance this year, the 2012-14 targets have been revised by the government from the SGP. The German government expects 0.5% deficit in 2012 instead of 1%.
BBVA Forecast				-0.6	-0.5	
Interest payment		-2.5	-2.6	-2.4	-2.3	We expect that the new targets will be broadly met and no risks are foreseen.
Cyclical		-1.0	-0.1	-0.4	-0.5	
Cyclically adjusted excl. Interests		-0.8	1.7	2.3	2.3	The phase-out of previous stimulus measures will do most of the job to bring back a balanced budget.
Structural adjustment			2.5	0.5	0.0	
General Government Debt		83.0	81.2	82.0	79.3	Debt will increase in 2012 due to the inclusion of the contributions to the EFSF/ESM.
Central budget execution (y.t.d.)	bn €	-27.1	-18.2	up to Jun '12		Budget execution is performing well, as interest rate bill has declined and economic activity is sustained.
	% of GDP	-1.1	-0.7			
France						
Government Deficit Target	% of GDP	-7.1	-5.2	-4.5	-3.0	The recently appointed cabinet has kept its commitment for 2011, but delayed until 2017 the balanced budget.
BBVA Forecast				-4.6	-3.3	
Interest payment		-2.4	-2.6	-2.6	-2.6	Meeting the targets is under risk, as the new government is debating whether to introduce the measures announced by the previous government and plans to eliminate the social VAT.
Cyclical		-1.3	-1.1	-1.6	-1.8	
Cyclically adjusted excl. Interests		-3.3	-1.4	-0.4	1.2	The new cabinet announced in July additional tax measures amounting €7.2bn (0.3%) to cover for estimated slippage in budget execution.
Structural adjustment			1.9	1.0	1.6	
General Government Debt		82.3	86.0	89.3	90.8	Debt is expecetd to remain at high levels.
Central budget execution (y.t.d.)	bn €	-68.4	-69.6	up to May '12		Budget execution up to May is hardly showing any improvement with respect to the same period last year.
	% of GDP	-3.4	-3.4			
Italy						
Government Deficit Target	% of GDP	-4.5	-3.8	-1.7	-0.5	The targets for 2012 and 2013 were slighly revised in the April's SGP from -1.5% to -1.7% and from -0.1% to -0.5%, respectively, due to worse economic activity performance.
BBVA Forecast				-1.9	-0.9	
Interest payment		-4.5	-4.8	-5.3	-5.6	Although some measures are a source of downward risks, such as the positive impact of fighting tax evasion, we expect targets to be close to be met.
Cyclical		-0.8	-0.6	-1.3	-1.5	
Cyclically adjusted excl. Interests		0.8	1.6	4.7	6.3	Additional measures announced in July together with others due to be implemented in H2 will help to improve the balance.
Structural adjustment			0.8	3.1	1.6	
General Government Debt		118.6	120.1	125.3	127.6	Debt will continue increasing.
Central budget execution (y.t.d.)	bn €	-43.9	-26.8	up to Jul '12		Budget execution at the central government up to July has improved with respect to last year, although the overall year target was met already in June.
	% of GDP	-2.8	-1.7			

Continued on the next page

Table 1
BBVA Eurozone Budget monitor (cont.)

		2010	2011	2012	2013	Comments
Spain						
Government Deficit Target	% of GDP	-9.3	-8.9	-6.3	-4.5	The final figure for 2011 was subject to several revisions. The target for 2012 was relaxed by 1pp.
BBVA Forecast				-6.3	-5.0	
Interest payment		-1.9	-2.4	-3.2	-3.4	We foresee that the target will be met this year, but more measures will be required so as to meet 2013-14 targets.
Cyclical		-0.9	-1.0	-1.8	-1.8	
Cyclically adjusted excl. Interests		-6.5	-5.5	-1.2	0.1	In early August the government presented its bi-annual program with a savings plan that amounts to €102bn for H2 12-2014. Measures include a raise un the general VAT by 3pp from 18% to 21%, by 2pp the reduced to 10% and the reclassification of some of the products in the lower range to the general. Additional wage cuts to public servants.
Structural adjustment			1.0	4.2	1.4	
General Government Debt		61.2	68.5	81.7	87.9	Debt will increase in 2012 in line with the increase of deficit during the previous year.
Central budget execution (y.t.d.)	bn €	-27.9	-43.1	up to Jun '12		Budget execution up to June is hardly showing improvement, due to the worsening economic activity. But most of the adjustment is expected to take place during the second half of the year and the reversal of transfers to autonomous regions.
	% of GDP	-2.6	-4.1			
Greece						
Government Deficit Target	% of GDP	-10.6	-9.3	-6.7	-4.6	Greece revised its deficit targets and is asking for an extension of the program of at least 2 years, as the implementation of measures is not showing the expected results.
BBVA Forecast				-7.6	-6.8	
Interest payment		-5.8	-7.0	-7.2	-7.1	This year targets are unlikely to be met, as the effectiveness of some measures are lagging behind and economic activity is expected to fall more than initially expected.
Cyclical		-0.3	-2.1	-4.2	-4.5	
Cyclically adjusted excl. Interests		-4.4	0.0	3.8	4.8	€11.5bn on spending cuts agreed for 2013-2014. Details to be announced the following week(s).
Structural adjustment			4.4	3.9	1.0	
General Government Debt		145.0	165.3	165.4	173.4	Greece plans to raise €19bn by 2015 via privatizations, and €50bn over the medium term. It generated less than €1bn over the last three years, but missed the target of €3.2bn this year, which may lead to a higher debt than initially expected.
Central budget execution (y.t.d.)	bn €	-13.1	-12.5	up to Jun '12		Hardly any improvement with respect to last year.
	% of GDP	-6.1	-6.1			
Portugal*						
Government Deficit Target	% of GDP	-9.8	-4.2	-4.5	-3.3	April SGP introduced minor changes on their target, but they remain broadly the same.
BBVA Forecast				-4.6	-3.6	
Interest payment		-2.9	-3.9	-4.3	-4.4	We do not foresee major hurdles to meet this year target, during the second part of the year the Christmas subsidies to employees will be cut.
Cyclical		-0.5	-1.0	-1.4	-1.6	
Cyclically adjusted excl. Interests		-6.4	0.6	1.2	2.4	There are risks in 2013 as the Constitutional court decided that the wage cuts at the public sector are unconstitutional. The government will need to find €1.1bn.
Structural adjustment			3.5	4.1	1.2	
General Government Debt		93.3	107.8	114.0	117.1	Debt will reach its maximum by 2013.
Central budget execution (y.t.d.)	bn €	-4.0	-1.2	up to Jun '12		Budget execution is performing broadly in line with targets and better compared with the same period last year. Revenues are lagging behind, as VAT collection fell, but compensated the good performance in current spending constraints. Although overshadowed by high interest payments.
	% of GDP	-2.3	-0.7			

(*) It includes the transfer of the pension funds. To follow-up fiscal developments it is not an easy task due to the wide-range of statistics provided with different frequencies, timeliness, coverage and the way of handling the data. On a monthly basis usually only the figures at the central /federal level are available and usually based on a cash-basis, while on a quarterly basis data based on an accrual basis or ESA 95 is published but with a substantial delay in time
Source: Eurostat annual and quarterly financial statistics, National Stability Growth Pact documents submitted in April-May 2012, National Statistical sources and BBVA Research

Box 1. The dynamics of the TARGET2 balances

Target2 balances

TARGET2 balances arise from the cross-border distribution of central bank money within the decentralized structure of the Eurosystem. They are debts among National Central Banks (NCBs) that are aggregated across the eurozone by TARGET2 (the EU gross settlement system). TARGET2 allows commercial banks in Europe to settle their payment transactions on a shared platform and in central bank money, as well as allowing the settlement of Eurosystem central bank operations. The settlement of these cross-border payments in TARGET2 results in intra-Eurosystem balances which are automatically aggregated and netted out at the end of each day. This leaves each central bank with a single net bilateral position (i.e., claim or liability) vis-à-vis the ECB.

This structure provides stability in the European financial system, as banking systems in some countries that face net payment outflows need more central bank liquidity than those in other countries where commercial bank money is flowing in.

What explains the recent evolution and distribution of TARGET2?

In the current crisis, concerns on peripheral countries have contributed to a significant reduction of private capital inflows or even more recently to capital flight. This implies that external funding needs in these countries should be met by alternative funding sources. In the case of the banking system, it means that commercial banks in peripheral countries are facing difficulties in accessing market funding, in some cases (such as Greece) exacerbated by deposit withdrawals. Since 2007 the problem has been the deficient functioning of the European interbank market, which has led to its segmentation. This is a market failure which is forcing the ECB to intermediate the interbank flows. The situation is being prolonged and exacerbated by the sovereign crisis. All this has resulted in an increase in intra-system balances.

Until mid-2007, the Target2 accounts were virtually balanced. Specifically, the sum of all the positive balances of eurozone NCBs (or, alternatively, the sum of all the negative balances) stood at around €100bn, and the net position of each National Central Bank (NCB) tended to fluctuate around zero. Since then, however, the net position of NCBs has shown a systematic trend, as a result of net balance of payments flows (that cannot be financed any longer in the interbank market), and intra-ESCB positions have grown sharply. In particular, Target2 accounts almost doubled, from €436bn to €842bn, between December 2012 and December 2011. In May 2012, these balances surpassed €1.000bn.

The sharp rise in the TARGET2 balances thus also reflects the changed distribution in refinancing operations in the eurozone since the start of the financial crisis. This has been facilitated by the ample supply of Eurosystem liquidity as a result of the full allotment of all bids in the refinancing operations since October 2008, and more intensely, as a result of the two consecutive 3-year LTROs held in December 2011 and February 2012. This means that TARGET2 balances should not be added to the ECB liquidity provision, as they are the other side of the coin of the concentration of ECB lending in peripheral countries and of ECB deposit-taking in core countries. These balances do not affect the amount of monetary base available because, for a given monetary base growth, the distribution of liquidity is a result of the ECB still providing liquidity at a fixed rate and on a full-allotment basis.

What´s worrying about increasing TARGET2 balances?

According to May data, the Bundesbank[2] has the biggest claim position (€698.6bn: 68% of the total), while the Bank of Spain[3] and the Central Bank of Italy are the biggest borrowers (€345.1bn and €274.6 bn, 34% and 27%, respectively of the total amount), followed by the National Central Bank of Ireland (around €117bn).

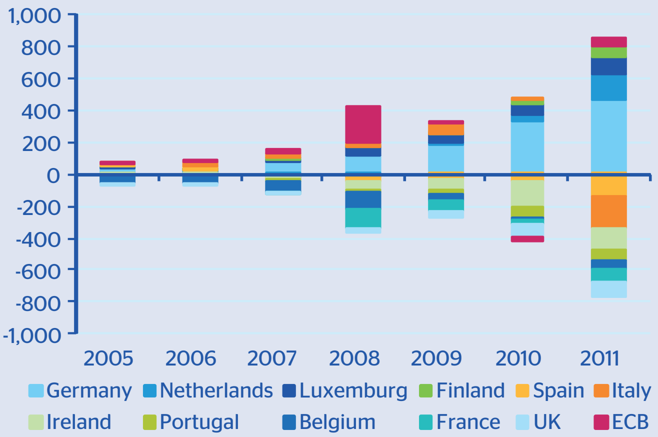
In terms of risks, the size and distribution of the target accounts across the Eurosystem central banks are, however, irrelevant to their risk exposure by the provision of funds from the Eurosystem. For that reason, this does not create any additional risk not already contained in monetary policy refinancing operations. Therefore, no matter which national central bank executes the Eurosystem refinancing operation, any losses (or profits) would be shared among the NCBs of the Eurosystem. In other words: these intra-ESCB positions are only the result of the decentralized execution of monetary policy, and thus they would not exist if all the operations desks of the NCBs were moved to Frankfurt and all the lending was directly done by the ECB.

These intra-ESCB positions would only be settled in the case of a euro break-up. Only in this case would these positions imply a problem, both for net debtors (which will probably not be able to settle them) and for net creditors (which will not recover their claims). By insisting in the relevance of these positions, German analysts (and more recently the Bundesbank) are conveying the view that they see a certain risk of a euro breakup, creating a dangerous self-fulfilling expectations circle.

2: June data: €728.6bn
3: June data: €408.4bn

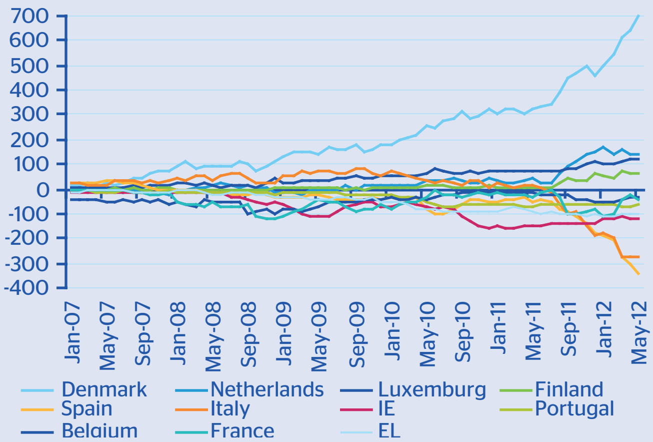
This situation of uncertainty, especially in the eurozone peripheral countries, suggests that balances will not shrink rapidly, but rather will continue to increase in the coming months if they should finance not only the current account deficit, but also capital outflows. As net positions accumulate, the campaign in Germany against full allotment or LTRO will intensify, putting a potential limit to the ECB support to peripheral banks, at a time they badly need it. All this intensifies the urgency of finding ways to reopen the interbank market.

Chart 7
Net balance with the Eurosystem/Target[4] (bn euros)



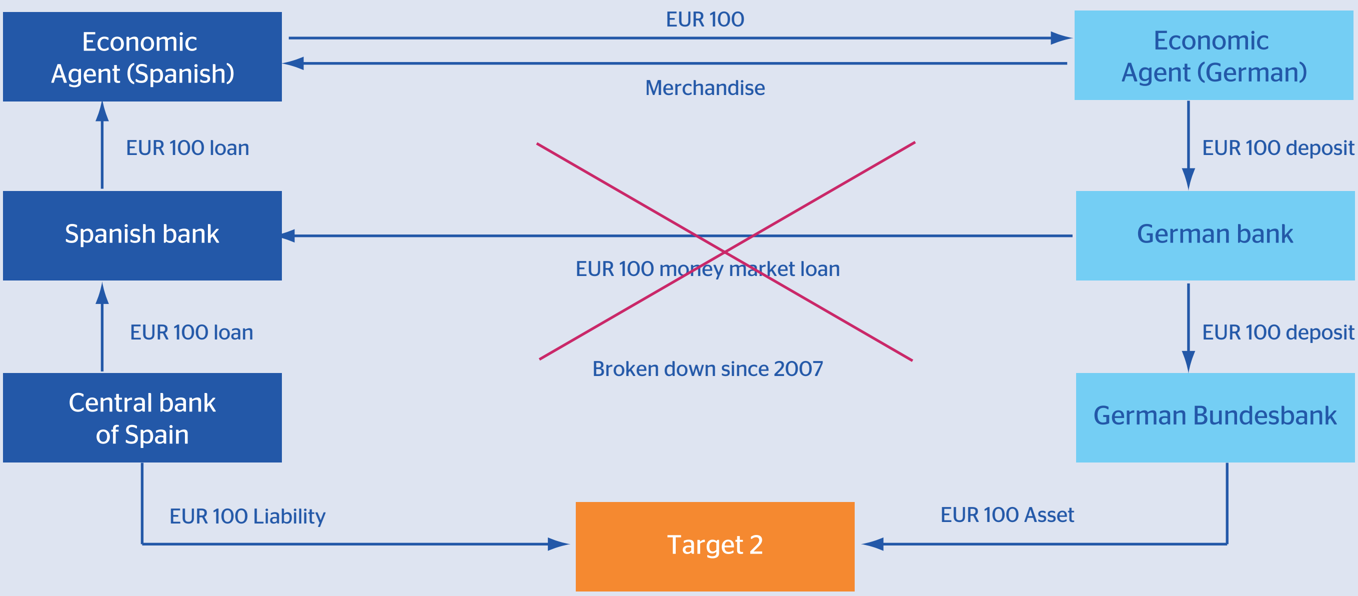
Source: National Central Banks and BBVA Research

Chart 8
Net balance with the Eurosystem/Target (bn euros)



Source: National Central Banks and BBVA Research

Chart 9
Target2 balances



Source: BBVA Research

4: Intra-Eurosystem exposure has two components: Claims/liabilities related to the allocation of euro banknotes within the Eurosystem and other claims/liabilities within the Eurosystem (net). The second item consisted mainly of the TARGET2 balances of the eurozone NCBs vis-à-vis the ECB and which has been considered as TARGET position in this note.

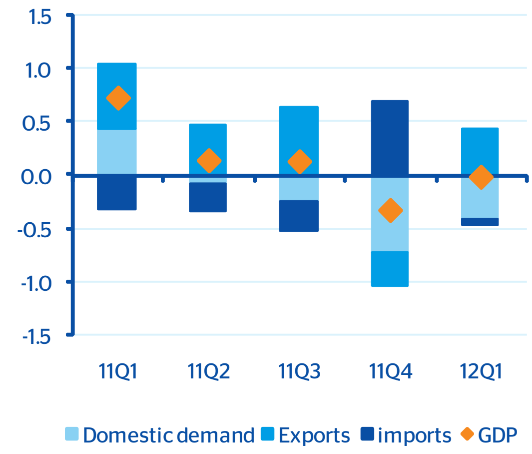
3. Eurozone economic outlook

Economic activity in the Eurozone contracted again in the year's second quarter after stagnating in the first

The measures adopted by European authorities at the end of last year and beginning of this year (e.g. the ECB's extraordinary liquidity measures in December and February, progress in the fiscal pact and the ESM, approval of Greece's second bailout) helped stabilise economic activity in the first quarter of 2012. The measures helped to reduce financial stress considerably (Chart 3) and to ease credit conditions slightly, bolstering confidence among economic agents. Eurozone GDP was stagnant in the first quarter this year, as expected, with net trade making a significant contribution as exports remained robust, while the performance of imports showed the steep fall in domestic demand (Chart 10). Looking more closely at the key fundamentals underlying this performance, a more lax monetary policy provided the only support to activity, whereas the fiscal consolidation process posed a drag on growth that was not offset by the substantial improvement in financial conditions (Chart 11).

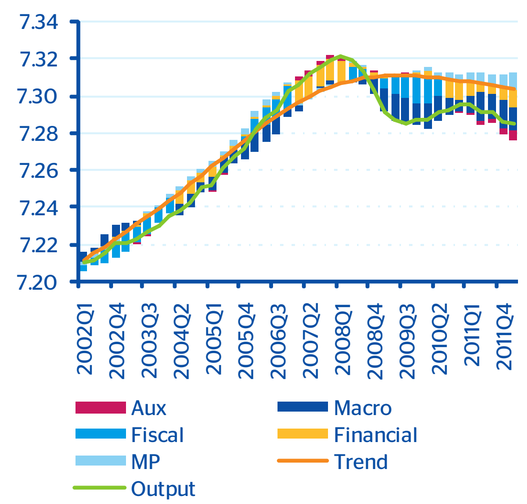
First-quarter readings showed a more mixed economic performance across member states, due mostly to differences in fiscal consolidation requirements, the degree of economic deleveraging and the situation of the countries' banking systems and labour markets. Germany's economy grew more than expected (+0.5% q/q), while GDP stagnated in Italy and contracted sharply in Spain. We expect these differences to persist going forward, so data should remain varied in the coming months, although the latest releases indicate that Europe's core countries are not impervious to the crisis in the periphery.

Chart 10
EMU: GDP growth (% q/q) and contribution by components



Source: Eurostat and BBVA Research

Chart 11
EMU: output, trend and shocks



Source: BBVA Research

Nonetheless, as we pointed out in our previous report (Europe Economic Outlook, Second Quarter 2012), the aforementioned measures provided just a window of opportunity to improve fundamentals, mainly linked to sovereign debt conditions, which Europe's authorities failed to draw up permanent measures in the first half of the year that would provide a definitive solution to the crisis in Europe. As a result, financial stress flared back up in March, returning to levels seen at the end of 2011 (Chart 3).

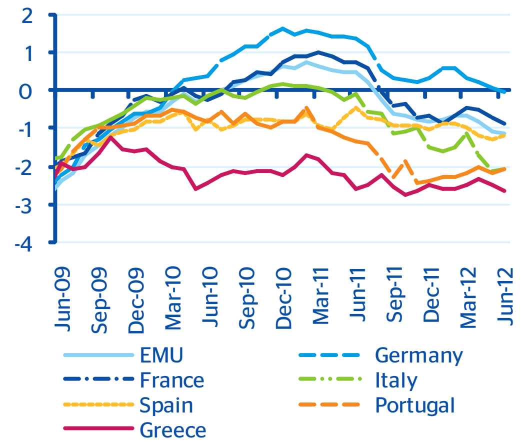
Economic data released so far provides evidence of this and suggests that economic activity contracted again in the second quarter. Both European Commission (Chart 12) and PMI confidence indicators deteriorated sharply in April and May, falling back to end-2011 levels, when GDP contracted 0.3% q/q, although June's readings indicate that the pace of decline eased towards the end of the second quarter.

The drop in confidence, coupled with the fall in real disposable income caused by the continuous rise in unemployment and tax hikes related to fiscal adjustments, not to mention still-high inflation, triggered a sharp rise in the saving rate for precautionary reasons and a fall in household spending. Particularly, retail sales through May were 1% lower than in the first quarter and in line with levels seen at the end of last year, when private consumption contracted by 0.5% q/q.

Meanwhile, the global economic slowdown is hurting exports, which through May were 0.5% lower than in the first quarter. This is one reason why industrial production is falling. Trends in industrial orders and downbeat expectations for demand are likely to continue undermining the decisions of companies, thereby causing both investment and employment to fall.

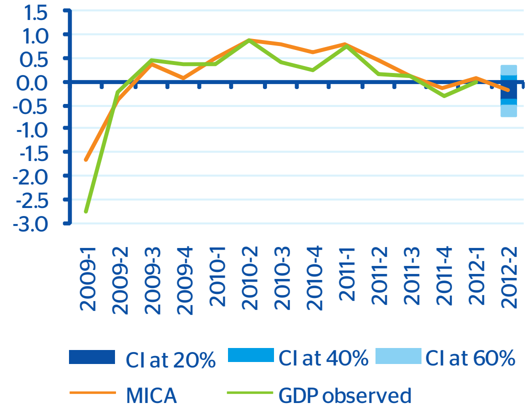
In sum, considering all this information, our short-term model (MICA) estimates a contraction in GDP of around -0.2% q/q in Q2-12 (Chart 13), although our macroeconomic outlook points to a slightly stronger contraction, of -0.3% q/q, as do the rest of our models. This is because the indicators used in the short-term model could be factoring in a certain delay in the fiscal adjustment and the spike in financial stress.

Chart 12
EC economic sentiment (standardized)



Source: European Commission and BBVA Research

Chart 13
EMU: MICA-BBVA and GBP observed (% q/q)*



Source: Eurostat and BBVA Research

Data for the third quarter are limited at present, with just PMIs and ESI confidence for July, although these suggest the eurozone will remain in recession this quarter. Nevertheless, both these and June's figures seem to show that the pace of deterioration in activity may have eased. Specifically, the composite PMI remained stable, as improved confidence in the services sector made up for further deterioration in expectations in the industrial sector. By country, both Germany and France are showing some causes for concern, with manufacturing confidence signalling a deeper recession, partly reflecting the slowdown in global demand, while the services sector was more resilient, suggesting that domestic demand in these countries should continue to buoy growth.

Finally, July figures also indicate that the economies of peripheral countries were tending to stabilise at the beginning of the third quarter. The information available so far is extremely limited, but is consistent with our outlook that eurozone GDP will contract further in the third quarter before stabilizing in the latter part of the year.

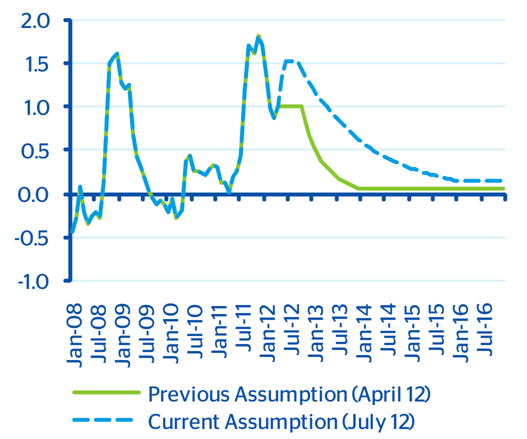
The negative impact of heightened financial stress will not be offset by the slight improvement in the rest of the fundamentals

Some of the main risks we highlighted in our scenario three months ago materialized in the second quarter. Above all, financial stress increased considerably, whereas in our previous scenario we expected it to remain relative stable at the low levels reached at the beginning of the year before easing towards the end of the year. This has prompted us to downgrade our economic forecasts for the whole eurozone for the second quarter. We now estimate a contraction of around -0.3% q/q, compared to -0.1% q/q previously, leading to a 0.1pp decline in average growth forecast for 2012.

We should stress that our outlook for the next two years depends considerably on how the eurozone crisis is managed. Specifically, we assume that the agreements reached at the June summit will be executed, even with all their problems, and that intervention by the ESM in the bond markets, possibly along with the ECB, will be credible and reduce financial stress, with the first signs of this coming in September. In the meantime, common banking supervision should allow for the direct recapitalization of struggling banks, which would help Spain and Ireland, while progress towards banking and fiscal union should help dispel doubts surrounding the future of the economic and monetary union.

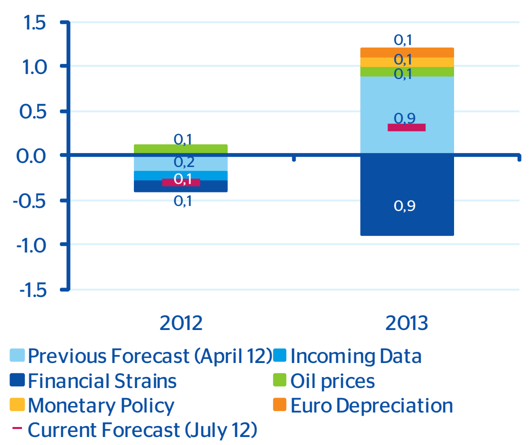
The main change in our assumptions relates to financial stress, as we now expect it to remain high over the next couple of months before beginning to ease in September, although it should remain higher than we were anticipating three months ago (Chart 14). According to our models, the new outlook points to a contraction in GDP of around 0.2pp in 2012, partially already reflected in indicators for the second quarter, with a greater impact on 2013 of around -1pp (Chart 15).

Chart 14
EMU: Financial stress index



Source: BBVA Research

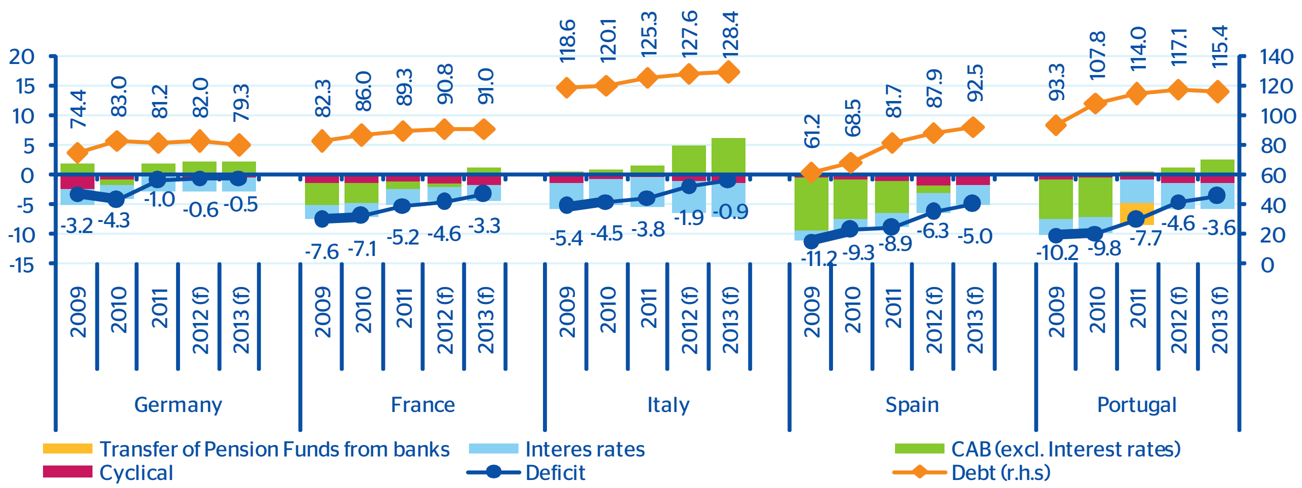
Chart 15
EMU: Annual GDP growth and factors



Source: BBVA Research

The fiscal consolidation process should continue to detract from growth, although our assumptions are broadly unchanged from three months ago. National governments have mainly outlined the set of measures they will adopt to achieve the targets set for Europe as a whole (Chart 16). In particular, peripheral countries have stepped up their fiscal efforts, while adjustment in others, such as Germany, should now be less than expected, since they virtually show balanced budgets after obtaining higher cyclical revenue than forecasted. As a result, fiscal efforts for the entire eurozone should be similar to those of 2011, when the deficit narrowed by 2.1pp to 4.1% of GDP. That said, the consolidation process will continue to undermine economic growth (Chart 11), as the gains derived from greater financial market stability will be unable to counteract the negative effects of austerity.

Chart 16
General Government deficit decomposition and public debt (% of GDP)



Source: Eurostat and BBVA Research

Finally, some positive changes in other factors could help make up for the impact of increased financial stress somewhat. First, a sharper slowdown in oil prices could feed through to higher economic growth, especially next year, of around +0.1pp. Second, the ECB shaved another 25bp off its key interest rate, the contribution of which, although marginal, could result in a 0.1pp increase in economic growth next year. Finally, because of the decoupling between the European and US economies, we now expect a slightly sharper depreciation of the euro than we did three months ago, which could add another one or two tenths to GDP growth in 2013.

After the slight recession in 2012, the economy will recover slower than forecast in 2013

Bearing in mind the abovementioned factors, our updated forecasts now point to a more pronounced recession in Q2, to be continued in the course of Q3, albeit easing slightly before ending the year with zero growth.

This implies a slight downgrade for 2012 as a whole compared to the -0.2% forecast from three months ago, with the probability of recession continuing to worsen standing at around 75%. This downgrade is largely due to the worsening financial stress in Q2-12, which could shave off 0.2pp from overall growth for the year (-0.1pp included in the data for Q2). However, this will be partially offset by the positive impact of lower oil prices and a sharper depreciation of the euro (by around 0.1pp).

Looking ahead to 2013, we expect continued financial stress to result in weaker growth in the first six months before picking up slightly in the second half. Therefore, the forecast for average annual growth has been cut 0.6pp to a mere 0.3%, although this includes a not inconsiderable 35% probability of recession.

External demand continues to drive the economy

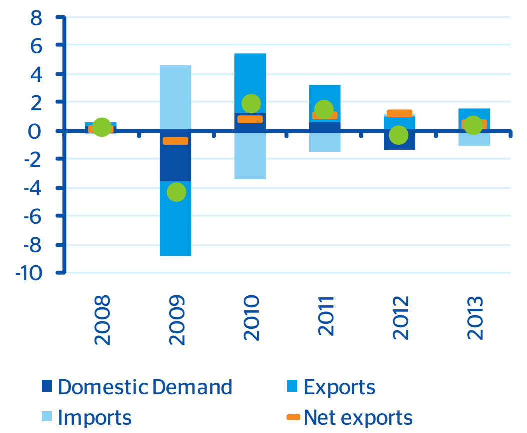
The recession will be shaped largely by domestic demand (Chart 17). Private consumption will contract sharply after the timid advances made in 2011, dragged down by dwindling available household income since mid-2011. This is due to lower salaries, higher taxes and a slowdown in inflation. Also, growing uncertainty about the eurozone and a worsening job market have hampered consumer confidence, resulting in a higher saving rate for precautionary reasons and thereby lower household spending, despite lower interest rates. Additional to all this, households, mainly in peripheral countries, are currently undergoing a deleveraging process.

Investment in 2012 is also being eroded by falling private consumption, the recent slowdown in the global economy, excess installed capacity and weaker corporate results, causing investment to contract sharply. Consumption and private investment are both expected to stagnate in 2013. Given this weak domestic demand and worsening fundamentals, credit restrictions caused by banking recapitalisation will have a limited impact on economic activity in 2012 (see European Economic Outlook, Fourth Quarter 2011), although this could prevent securing recovery for 2013. Unlike in the previous crisis when there was room to manoeuvre and apply expansionary policies, current fiscal adjustments intended to guarantee the sustainability of public finances will also trigger declining public consumption. In particular, the eurozone's public deficit will decline by 1pp to 3.1% of GDP in 2012, with higher public debt of slightly below 90%. In 2013, fiscal adjustments in place will trigger a further decline in public consumption.

Therefore, exports will remain the only source of growth, although they will decline sharply for the year as a whole, due to lower than forecasted growth for the global economy. However, sharper depreciation of the euro will continue to sustain exports competition. The sharp decrease in domestic demand will also cause imports to decline, with external demand contributing much more to growth in 2012 (+1.1pp) which will partly offset the negative contribution from internal demand (-1.5pp). In 2013, external demand will continue to contribute to growth, albeit to a lesser extent (+0.4pp), thanks to increasing global demand.

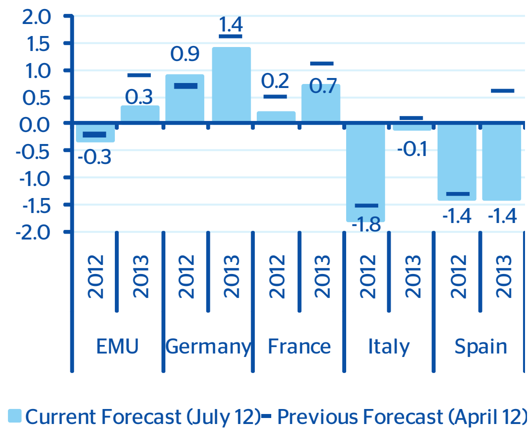
Against this backdrop, our forecasts indicate labour market deterioration over the coming quarters with higher job destruction (-0.7% in 2012 and -0.2% in 2013) and unemployment rising to 11.2% in 2012 and 11.5% in 2013.

Chart 17
EMU: Annual contribution to growth (pp)



Source: Eurostat and BBVA Research

Chart 18
EMU: Growth forecasts by country



Source: BBVA Research

Northern eurozone slowing with peripheral countries still clearly in recession

The worsening crisis in the peripheral countries will be felt across eurozone, with the bad economic performance spread to all member States (Table 2). However, as we have seen in recent quarters, there will be marked differences between the countries this year. Northern and Central Europe will slow sharply, although growth rates will remain positive (Germany and France). Meanwhile, GDP in peripheral countries (Portugal, Italy and Spain) will suffer pronounced declines (Chart 18). This difference is mainly due to the impact of the various macroeconomic adjustment processes under way, which will largely shape domestic demand, while exports will continue to be the main driver of growth in all countries.

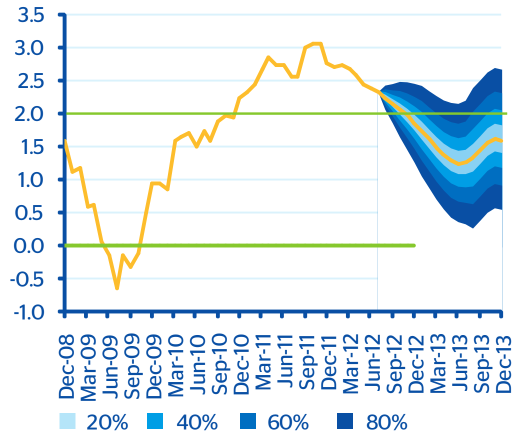
In 2013, the incipient recovery forecasted for the eurozone will not be broad-based. Despite the attempts to solve institutional problems across Europe, peripheral countries will continue to correct accumulated economic imbalances. In this regard, our forecasts point to some consolidation of recovery, albeit slow, in Central and Northern European countries, while the peripheral countries would remain in recession (Chart 18).

Inflation below 2% from the end of the year

Turning now to prices, our forecasts point to slowing inflation for the eurozone as a whole over the coming months before ending the year slightly below the ECB's target of 2% y/y. For 2012 we have lowered our forecast for average annual inflation by 0.1pp to 2.3%, largely due to lower oil prices. This contrasts with our estimate from three months ago of rising prices. Given weak domestic demand, underlying inflation will also continue to ease over the coming months to end the year at around 1.7% y/y, giving an annual average of 1.8%. The slowdown will continue in 2013 with an annual average rate of around 1.4% for general and underlying rates (Chart 19).

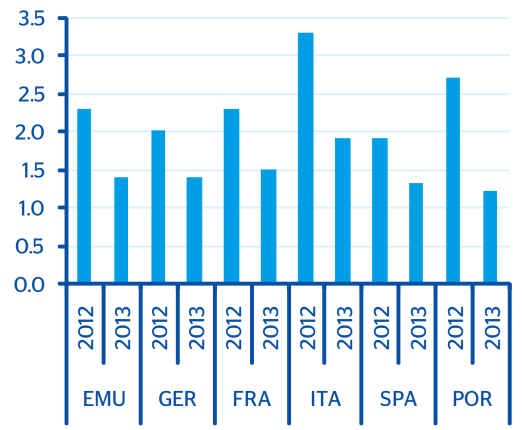
By countries we will also see marked differences in inflation rates (Chart 20). While downward pressure on prices due to weak domestic demand is widespread, higher inflation in some peripheral countries (Italy and Portugal) is basically due to higher taxation arising from fiscal consolidation measures.

Chart 19
EMU: Inflation (% y/oy)



Source: Eurostat and BBVA Research

Chart 20
EMU: Inflation forecasts by country



Source: BBVA Research

Risks to economic activity still tilted to the downside

Downside risks to our growth scenario are varied, and depend on future events, which could trigger a sharp increase in financial stress and risk aversion. Even though the threat of Greece leaving the euro still lingers, the main source of uncertainty at the moment comes from implementing the agreements reached at June's summit. This includes final German approval for the ESM (due in September), the swift introduction of a common banking supervisory mechanism leading to direct recapitalisation of some banks by the ESM, and approval of a roadmap for greater, more credible and ambitious integration. Should financial stress worsen, it is important that the European authorities (the EFSF, ESM and ECB) guarantee that liquidity is available in the main financial markets.

Finally, there are certain extraneous risks (raw material prices and a sharper-than-expected slowdown in global demand) which cannot be ruled out. However, there are also some upward adjustments, such as a swifter response by the European authorities over the coming months, with more decisive action to implement some of the agreements already reached.

The risks in our inflation scenario are balanced. There are upward adjustments resulting from possible tax increases in the current fiscal consolidation processes as well as higher raw material prices (especially foodstuffs), while sharper depreciation of the euro could trigger higher imported inflation. Nonetheless, this might be offset by the downward risk stemming from a further slowdown in economic activity.

Table 2

Eurozone member states: a closer view

Eurozone: Recession in 2012, driven by more negative H1

GDP:	-0.3%	in 2012	+0.3%	in 2013	HICP:	+2.3%	in 2012	+1.4%	in 2013

Latest official data for Q1-12: GDP stabilized in Q1-12 (0%), beating expectations, on the back of continued external support. The trade volume accelerated (exports: +1.0%, imports: +0.1%), after slowing down in Q4-11, contributing positively to growth (+0.4pp). Domestic demand was weaker, with only private consumption remaining stable, after a drop of -0.5% q/q in Q4-11, while the fall in investment was sharper (-1.4% versus -0.4%, respectively). The stronger growth in Germany (+0.5% q/q) and the milder contraction in several periphery countries were accountable for this better than expected result.

Incoming data for Q2 and Q3: Incoming data in Q2 suggests that eurozone economy has entered in negative growth territory. Confidence deteriorated significantly during Q2-12, with PMI and ESI indicators pointing to weaker activity for both manufacturing and services, but it turned less negative at the end of the quarter. Industrial production recovered somewhat in May after bad figures in April, nevertheless remaining weaker than in Q1. There was a slight improvement in consumer confidence during Q2, but the recent rebound of retail sales could not offset the decline observed in April, while unemployment reached a record high in May-June (11.2%). External trade seems to be the most resilient component, with increasing volumes and significant trade surpluses throughout Q2 so far. Across countries, Germany seems to have also entered negative figures in Q2. Our short-term GDP forecast model (MICA-BBVA) suggests that economic activity has contracted by -0.2% q/q, but with risks being tilted to the downside (-0.3% q/q). This implies a slight downward revision compared to our latest Outlook in May (-0.1% q/q). For Q3, the only available data for July (PMI and ESI confidence) points to a less negative activity in services, while manufacturing is set to deteriorate further, weighing on investment.

Outlook for 2012 and 2013: For the current year we expect a contraction in eurozone GDP of -0.3%, with domestic demand weighing on growth, and more than offsetting the expected gain from net exports. The sharp projected fall in investment (-2.9%), will be the main reason leading to a negative contribution to growth of domestic demand of -1.5pp. For 2013, we anticipate a milder rebound, driven by external demand (+0.4pp), while domestic demand will stabilize (0.0pp).

Inflation outlook: Consumer price inflation eased to 2.4% in May-July, after remaining sticky at 2.7% during Q1. We continue to expect a slower moderation of prices in coming months, with inflation remaining above the ECB target over the next quarter and reverting to around 2% by the end of the year. Core inflation is likely to ease slightly and remain hovering around 1.7% y/y during the second half of the year, with risks to this scenario broadly balanced.

Public sector: During the last two months several countries, including France, Italy and Spain, announced additional fiscal measures with the aim to reach targets for this year and next. Regarding budget execution until today, we have not observed a notable correction with respect to the same period of the previous year. Therefore, the measures have not been sufficiently effective, mainly because their forecasted impact on revenue or spending were very optimistic, growth has been lower than expected, and interest payments have been increased.

Germany: Domestic demand the driver of growth for another two years

GDP:	+0.9%	in 2012	+1.4%	in 2013	HICP:	+2.0%	in 2012	+1.4%	in 2013

Latest official data for Q1-12: Germany experienced a significant rebound of activity in Q1-12, with GDP gaining 0.5% q/q. The external sector accounted for most of the improvement, with net exports contributing by 0.9pp to growth (with stable imports and expanding exports). On the domestic side, consumption (both public and private) was stronger, but investment fell sharply, resulting in a slightly negative contribution to growth (-0.3pp).

Incoming data for Q2 and Q3: Confidence in the economy deteriorated strongly during Q2, in line with the more pessimistic sentiment of the private sector, with manufacturing leading the negative developments. The services sector, though more resilient, has also entered contraction by the end of Q2, as PMI figures indicate. Looking at real activity, industrial production keeps trending upwards, with the exception of April, when also new orders experienced a significant fall. Consumer spending, as measured by retail sales, continued weakening during Q2, but the fall was milder compared to the previous quarter. Unemployment remains low and eased at 5.4% in June, after being sticky at 5.6% during each month of 2012 thus far up to May. As for confidence, households turned more pessimistic throughout Q2. The main reasons for the decreasing confidence should be related to external developments and the overall pessimism created by the extended European crisis. On the external front, trade volumes remain strong, with exports still taking the lead, thus granting Germany significant trade surpluses. For Q3, incoming PMI data suggests that services are recovering, while manufacturing is deteriorating further in July. ESI sentiment fell for the first time below its long-term average of 100, with both services and manufacturing falling strongly.

Outlook for 2012 and 2013: The higher resilience of German economy to the crisis lead us to revise further upwards our GDP forecast for 2012 to 0.9%, with mainly the domestic (0.6pp), but also the external demand (0.3pp) contributing positively to growth. We expect both private and public consumption to continue growing, though at a slower pace, as the labour market maintains its momentum, confidence remains in satisfactory levels and deficit came in lower than expected. Investment is seen easing significantly in 2012 (+0.3%), as a result of weaker industrial activity, but it is forecasted to recover during 2013 (+3.3%). Trade volumes will continue increasing this and next year, but imports will take the lead in 2013, as domestic demand remains strong. Therefore, net exports will continue supporting growth this year (0.3pp), but will turn flat in 2013, leaving domestic demand the only factor contributing to growth (1.4pp). For 2013 as a whole, we now expect a lower GDP growth of 1.4%.

Continued on the next page

Table 2

Eurozone member states: a closer view (cont.)

Germany: Domestic demand the driver of growth for another two years (cont.)

GDP:	+0.9%	in 2012	+1.4%	in 2013	HICP:	+2.0%	in 2012	+1.4%	in 2013

Inflation outlook: HICP inflation has been easing during Q2, falling to 2.0% in June, as a result of falling oil prices, while food prices are pushing on the opposite direction. Core inflation has also fallen, hovering between 1.4% and 1.7% in Q2. For 2012 as a whole, we continue anticipating an inflation rate of 2.0%, while for 2013 we revised slightly downwards our forecast to 1.4%.

Public sector: The budget execution of the federal government continues the good performance of the previous year. As a result, the German government has revised downwards its deficit objective for 2012 to 0.5% of GDP (from 1% of GDP in the stability plan of April). This improvement was mainly the result of both increased revenues and decreased spending in pensions, unemployment benefits and interest payments. Public debt is estimated to increase, mainly as a consequence of the contributions to the EFSF/ESM rescue funds.

France: Subdued growth in 2012 after flat Q1

GDP:	+0.2%	in 2012	+0.7%	in 2013	HICP:	+2.3%	in 2012	+1.5%	in 2013

Latest official data for Q1-12: In line with expectations, the economy during Q1-12 levelled off, escaping contraction once more, with contributions of domestic and external demand offsetting each other. Private consumption somewhat recovered (+0.2%), after the fall in Q4-11, while investment was weaker by 0.7%, leading to a domestic demand contribution to GDP growth of 0.1pp. During the same period, imports recovered, while exports growth eased, leading to a negative contribution of net exports (-0.1pp), after +0.3pp in Q4-11.

Incoming data for Q2 and Q3: In the course of Q2, France turned more pessimistic about the economic situation, leading confidence back to levels observed by end-Q4, though being on average broadly stable as compared to Q1. The positive PMI results of Q1 were reversed, to only improve somewhat in June, driven by a less negative services sector. In industry, following a slump in confidence, activity turned negative in May, after both new and current orders being stronger at the beginning of Q2. Consumer confidence and activity have been strong throughout H1, with restrained retail trade only at the beginning of Q2, but unemployment edged slightly up in May, after being stable for four months. Available data for Q3 (PMI) signals a less negative fall in private sector activity, on the back of stabilized services sector, while ESI confidence shows a stronger fall in services compared to the one in industry in July.

Outlook for 2012 and 2013: Due to worse than expected developments in the economy and additional austerity introduced by the government, we have revised downwards our projections for both the current and next year. We now expect GDP growth of 0.2% (versus 0.5% previously) this year, with equal contribution from domestic and external demand (+0.1pp), while for 2013 we see domestic demand taking the lead (+0.7pp).

Inflation outlook: HICP inflation has been gradually easing during H1, reflecting the deceleration of oil price increases in Q2. Over the quarter, both headline and core inflation came in as excepted, remaining broadly stable at 2.3% and 1.9% y/y respectively. Our HICP inflation forecast thus was only revised by 0.1pp to 2.3% in 2012, the same rate observed also in 2011, while we now expect somewhat lower inflation for 2013 (+1.5%).

Public sector: The central government budget execution is not very positive, as it follows a path very similar to the one of last year. A breakdown of the accounts shows that revenues are weaker than the targets, partly because the economy was weaker and partly because the impact of the measures was overstated. Independent auditors found a gap of €7.1bn (0.3pp of GDP) this year, leading to the announcement of new measures by the government in July. The objective for this year is a deficit of 4.4% of GDP, after 5.2% in 2011.

Italy: Continues in recession for at least two years

GDP:	-1.8%	in 2012	-0.1%	in 2013	HICP:	+3.3%	in 2012	+1.9%	in 2013

Latest official data for Q1-12: The Italian economy continued contracting in Q1-12, with GDP falling by -0.8% q/q, more than anticipated, with domestic demand shrinking, while though trade volumes decreased, net exports contributed positively to growth, as the fall in imports was more pronounced. Consumption remained subdued (-0.6%) and investment experienced another strong fall (-3.6%).

Incoming data for Q2 and Q3: Soft incoming data indicates that confidence in the economy fell even stronger during Q2, in line with the pessimistic picture of business confidence. Nevertheless, real industrial activity, after being negative in the dawn of Q2, made its way to growth in May and could continue expanding as the ESI survey suggests in June. As regards services, the outlook seems gloomier, as confidence deteriorated in each month of Q2. The prospects for consumption are mixed, with confidence taking the downturn throughout Q2, unemployment rising to 10.8% in June (+0.2pp on the month) while retail activity improving in May. PMI figures for July showed that activity in the private sector continued contracting strongly, while ESI confidence rebounded, due to increased optimism in services and among consumers.

Continued on the next page

Table 2

Eurozone member states: a closer view (cont.)

Italy: Continues in recession for at least two years (cont.)

GDP:	-1.8%	in 2012	-0.1%	in 2013	HICP:	+3.3%	in 2012	+1.9%	in 2013

Outlook for 2012 and 2013: The large fiscal adjustment undertaken in Italy is weighing on demand, while the economic contraction came in stronger than expected, due to the intensification of the crisis. Thus, we have updated our GDP forecast to a stronger fall of around -1.8% in 2012 (from -1.5% previously) and the economy will not return to growth until 2014. As an immediate effect of the measures imposed by the government, consumption is expected to drop significantly this year (-2.3%) and less strongly in 2013 (-0.6%), which together with weak investment prospects will lead to very negative contribution to growth in 2012 (-3.3%). The expected rebound in investment (+0.2%) next year would lead to a less negative contribution (-0.5%). On the external front, though the trade growth will be easing, net exports will drive growth in both years, nevertheless being unable to offset the negative effect of domestic factors.

Inflation outlook: Inflation was sticky also during Q2, averaging at 3.6% y/y, mainly reflecting increases in tax hikes. If we adjust for these factors, the rate eases to around 2.5%, but there is still uncertainty surrounding additional tax rises within a year from now. All these facts lead us to revise further upwards our forecast for 2012 to 3.3%, but we leave unchanged our projection of 2013 (+1.9%).

Public sector: There is a notable improvement in the budget execution of the central government through July, compared with the same period in 2011, although several local administrations are facing problems. However, the recently announced measures, along with the previous taken in December 2011 should be sufficient to approach the fiscal goal of a 1.7% deficit to GDP in 2012, after reaching 3.8% the previous year. The new deficit cuts amount to €26bn until end 2014, with €4.5bn for 2012, €10.5bn in 2013 and €11bn in 2014. This year's spending measures aim at avoiding the increase of VAT by 2%, which has been postponed until mid-2013.

Portugal: Milder recession, but no return to growth until 2014

GDP:	-2.6%	in 2012	-0.3%	in 2013	HICP:	+2.7%	in 2012	+1.2%	in 2013

Latest official data for Q1-12: GDP almost stagnated in Q1 (-0.1% q/q), beating expectations for a stronger fall, as investment surprised on the upside gaining 3.2%. In contrast, both private and public consumption continued falling (-2.1% and 0.6% respectively), reflecting the strong adjustment currently undertaken. Net exports were growth-neutral, as imports followed closely exports.

Incoming data for Q2 and Q3: Economic confidence remains at low levels, but it kept rising during Q2. In industry, sentiment is turning more positive and the rebound in activity was halted only for a month at the beginning of the Q2. Services could not follow, with their climate losing ground throughout Q2. The upward trend in consumer confidence started being reflected in retail sales only in May, after two consecutive months of decreasing volumes, while unemployment remains stubbornly high and is seen increasing. Our MICA-BBVA model suggests GDP will shrink by -1.1% q/q in Q2. For Q3, ESI indicator fell back in July, driven by increased pessimism in industry.

Outlook for 2012 and 2013: Taking into account the MICA's estimation for Q2 (-1.1%) and maintaining our quarterly growth path for Q3 (-0.6%) and Q4 (-0.3%), the annual GDP contraction should be -2.6% instead of -2.9% previously projected, to be followed by a mild contraction in 2013, with external demand always driving growth (3.5pp and 1.4pp in 2012 and 2013 respectively). Private consumption and investment are foreseen contracting strongly in 2012, with a softer fall in 2013.

Inflation outlook: After remaining at high levels during Q1, inflation started easing, with HICP averaging at 2.8% y/y in Q2 and core inflation at 1.6%. While the effects of the tax hikes during 2010-2011 should be disappearing, there is a high chance that the government imposes new rates increases, in order to achieve fiscal targets, which could lead to an negative effect on the price index. Our forecasts suggest that inflation would ease further to 2.7% this year and fall as low as 1.2% in 2013.

Public sector: The state deficit from January to June is estimated at €3.2bn, compared to a figure of about €6bn in the same period last year. The sharp fall, however, was due to a one-off revenue increase of €2.7bn from the transfer of pension funds from banks to the government. Otherwise, tax revenues fell by 3.1% in H1-12, partially being offset by a fall in expenditure of about 2.2%. The good performance on the spending side (i.e. reduction in public consumption, purchase of goods and services) is overshadowed by the increase in the interest rates bill and capital expenditure.

Continued on the next page

Table 2

Eurozone member states: a closer view (cont.)

Spain: Recession in 2012 and slow recovery in H2 2013

GDP:	-1.4%	in 2012	-1.4%	in 2013	HICP:	+1.9%	in 2012	+1.3%	in 2013

Latest official data for Q1-12: GDP continued falling in Q1-12, by -0.3% q/q. The disaggregation of GDP shows that domestic demand continued driving the fall (-3.2pp), especially on the back of falling investment, while external demand remained strong, though with its contribution lessened (from 3.2pp to 2.8pp).

Incoming data for Q2 and Q3: Pending detailed results, the GDP forecast published by INE suggests that the Spanish economy contracted by -0.4% q/q in Q2-12, rounding off three successive quarters of negative growth. If confirmed, this means the economy was performing in line with our expectations (BBVA Research: -0.4% q/q, MICA-BBVA 0.3% q/q), which had long been warning of another negative quarter and suggest the economy will continue to shrink through Q3. In addition, partial economic indicators available at the time, point to a further weakening of domestic demand in Q2-12, which would have eroded imports, implying that growth was again marked by rising net foreign demand and a negative contribution from the domestic component.

Outlook for 2012 and 2013: In sum, the Spanish economy looks set to stay in recession for the next few quarters and, under our central scenario, GDP is set to shrink by 1.4% during 2012 as a whole. In these circumstances we expect no economic recovery before the second half of 2013 and a full-year 2013 performance no better than 2012. Although the changes to the scenario set out above already represent a downgrading of the growth outlook for 2013, the risks of a yet steeper contraction remain high.

Inflation outlook: In 2Q, both headline and underlying inflation were broadly stable at around 2.0% y/y and 1.2% y/y, respectively. This, however, masked significant movements in some CPI categories. Of the 1.9% y/y inflation to June, 1.4pp was attributable to rising energy and food prices and just 0.5pp to services and non-energy industrial goods, where weak domestic demand continues to damp any inflationary pressure. HICP figures showed that in Q2 Spanish inflation undershot the eurozone average by around 0.6pp.

Public sector: Budget execution data suggests that the bulk of the cuts in public sector demand will come in the second half of the year. The deficit across all sections of government totalled 1.4% of GDP in Q1-12, reflecting the sapping effect of the deteriorating economy on public finances, especially on tax receipts. By sector, only the central government recorded a deficit in 1Q (-1.9% of GDP), and this was partly offset by a slight surplus in the other authorities (regional governments balanced their budgets), all of which were helped by bringing forward transfers from the Central Administration.

Looking at Q2, the latest central budget execution data through June showed a deficit of 4% of GDP, 0.5pp higher than the objective for the whole year. The advanced transfers to other public administrations, mainly autonomous regions and social security funds explain the rise in deficit. The consumption has moderated strongly (especially the intermediate consumption) but the negative evolution of revenues does not show an improvement. However, since a large part of the fiscal consolidation measures regarding the regions were defined when rebalancing plans submitted in May, it is expected that the greatest impact on the deficit will be observed during the second half of the year.

Source: BBVA Research

Box 2. Portugal: Towards a milder recession this year and nearing stagnation in 2013

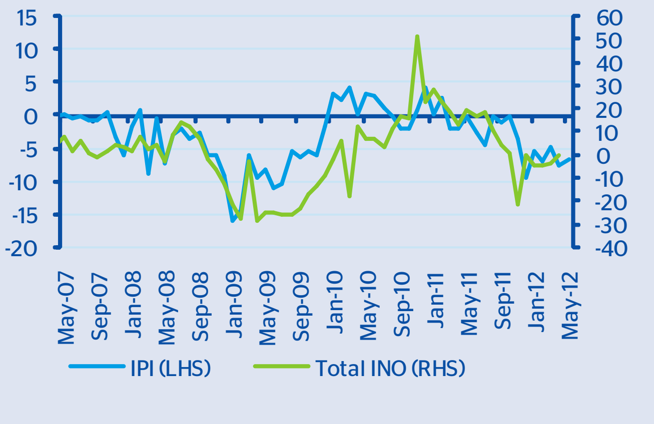
Economic activity continues to decline, as the macroeconomic adjustment goes forward and domestic demand is fading on account of the strong consolidation effort, but the downturn is expected to be less strong than anticipated given the better than expected results in Q1 and the continuing support of external demand. Hence, we forecast a milder fall of GDP for this year (at -2.6% instead of -2.9%) and a contraction of just -0.3% for 2013.

Indicators point to a sharp contraction in Q2, driven by domestic factors...

The mild fall of economic activity in Q1-12, at -0.1% q/q, was supported by a less negative evolution of domestic demand than expected and a still resilient contribution of net exports. However, as incoming indicators suggest, the contraction during Q2-12 is expected to have been stronger, reflecting a steeper fall in domestic demand and a deceleration of exports. In particular, on the domestic side, economic confidence improved only slightly after the significant upward movement observed in Q1 and still remains at low levels. Investment weighs further on activity, especially as the construction sector is registering steep falls in output and confidence. The investment survey of INE in April showed that investment is expected to decrease further by -16.7% during 2012, after the -15.8% expected for 2011, which came in less negative (at -14%), with the worsened sales perspectives as the main limiting factor, followed by the uncertainty surrounding interest rates. As regards industrial production, after increasing in each month of Q1 it fell back in April and was not completely offset in May (-6.5% and +4.1%, respectively). What is more, confidence in the services sector deteriorated significantly, losing 2p, after stabilizing in Q1. On a positive note, the evolution of the services turnover has turned positive in April-May.

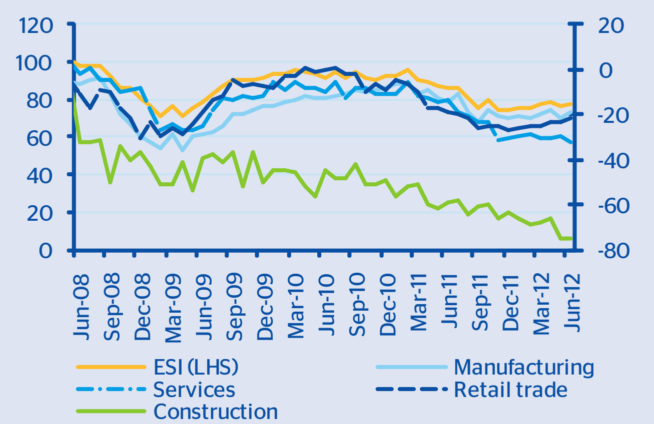
The prospects for consumption are not positive either, although they are in line with the necessary deleveraging of the household sector. Consumer confidence is steadily improving, while the labour market remains on a costly adjustment process, with unemployment gradually rising (+0.6pp during 2012 so far). Additionally, retail sales remain very volatile, following a pattern of falls and rises on a monthly basis. The tax hikes during the last years not only have negatively affected disposable income of households, but they have also kept inflation on higher levels than one would expect, given the current contraction of the economy. Nonetheless, HICP inflation has been easing gradually in recent months, reaching on average 2.8% y/y in Q2, after 3.3% in Q1, with core inflation at 1.6% and 2.0% respectively.

Chart 21
Portugal: Industrial sector (%y/y)



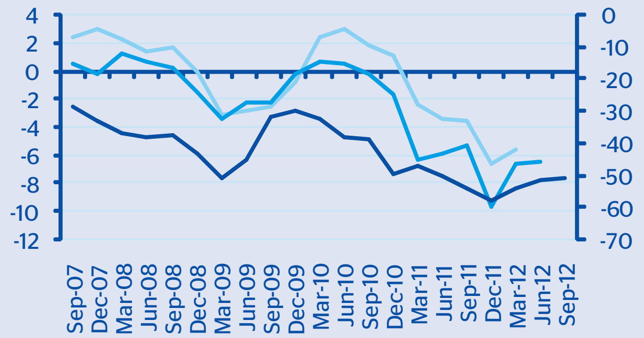
Source: Eurostat and BBVA Research

Chart 22
ESI confidence, by sector



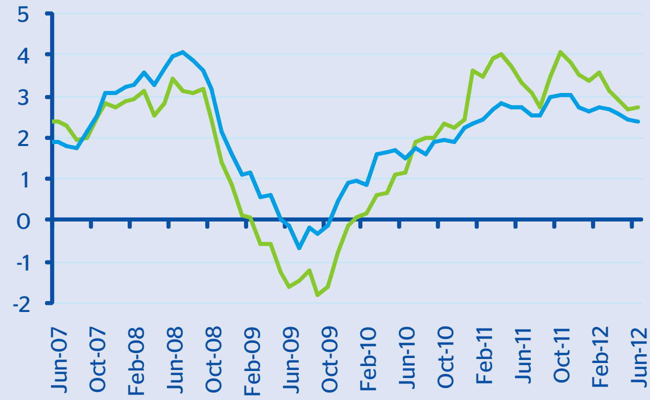
Source: European Commission and BBVA Research

Chart 23
Portugal: Priv. Consumption, Retail Sales and Consumer Conf.



Source: Eurostat, European Commission and BBVA Research

Chart 24
Portugal: HICP inflation (%y/y)



Source: Eurostat and BBVA Research

...while the support of external demand is weakening somewhat from the strong record at the beginning of the year

The external sector continued supporting growth during Q2, but less than previously. Exports have been growing and imports have been falling throughout 2012 so far on an annual basis, but the rise of exports eased in May. Furthermore, on a monthly basis, during Q2 imports recovered and started growing, while at the same time exports experienced a fall in May, leading to an increased trade deficit. Lastly, on a three-month moving average basis, growth in exports decelerates as well (1.4% 3mma to April, 0.8% to May).

Taking into account all this information, our MICA-BBVA model suggests a -1.1% q/q GDP fall in Q2, while we maintain our quarterly growth path for Q3 (-0.6%) and Q4 (-0.3%). The carry over effect of better than expected figures in Q1 means that the GDP fall should be lower in 2012 as a whole than previously estimated.

Outlook for 2012-2013 slightly improved

According to our forecasts, domestic demand will continue contributing negatively to growth (-6.0pp in 2012), with both private and public consumption falling strongly, but with the drop expected to ease in 2013. The strongest fall will be experienced in investment, both during this and next year. In contrast, net exports are expected to continue their positive contribution, though at a slowing pace in each of the two years.

On the back of more positive news about the Portuguese economy, the troika, the Bank of Portugal and the Portuguese government, all revised their forecasts upwards. The troika now expects a GDP contraction of -3% (from -3.3% previously), while it sees positive, though very low growth in 2013. The Bank of Portugal now expects better results for 2012 (-3.0% from -3.4% in Spring review), while it left unrevised its projections for 2013. Lastly, the government now estimates the GDP growth at 0.2% in 2013, well below the 0.6% it estimated in April, while it revised upwards its forecast on unemployment, now foreseeing a peak at 16% in 2013 (previously the peak was at 14.5% in 2012).

Fourth review of troika once again applauds Portugal's efforts

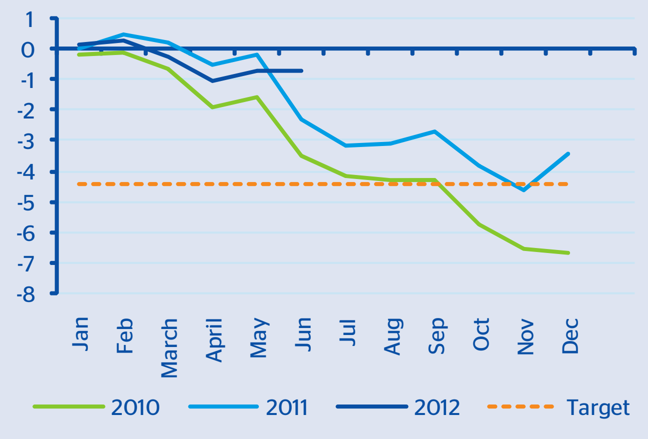
The mission of the troika completed its fourth review at the beginning of June, giving a positive assessment, and highlighting their continued confidence on the feasibility of fiscal targets. At the same time, it encouraged the country to proceed with structural reforms (i.e. labour market, price competitiveness) as means to boost growth in the long-run. Unemployment, which international creditors see peaking at 16% in 2013, is considered a major challenge, but is seen as a by-product of the transition to a more export-oriented economy (and as a result of rigidities in the labour market). The next review is scheduled for September.

Budget execution is improving, but the risk of meeting the deficit target is increasing, as revenues are lagging behind

The government deficit through June has shown a significant improvement over last year (€-3.2bn, compared to €-6bn). Including the surplus recorded by autonomous funds and social security, the improvement become more significant, (€-1.2 bn, compared to €-3.8bn), but is mainly explained by the inclusion of the transfer of pension funds in the banking system, estimated at €-2.7bn. Without those extra revenues, there is no improvement from the same period a year ago.

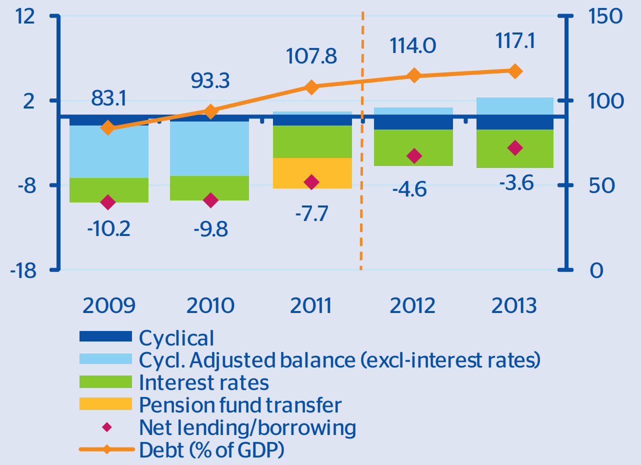
The analysis shows that income items for direct and indirect taxes are below targets. Thus, current revenues are down 1.4% over the same period last year. On the expenditure side, current expenditure fell slightly by 0.5%. Although most categories showed significant declines in line with the consolidation undertaken (for example, the wage bill was reduced by 16.8% and subsidies by 25%), interest payments have risen by 20% and have offset the positive performance of other expenses. Ultimately, the goal of reducing the deficit of the general government from 7.7% in 2011 (4.2% if we include extra income from the transfer of pension Portugal Telecom) to 4.5% (government target) is becoming more difficult.

Chart 25
Portugal: Budget execution % of GDP



Source: DGO and BBVA Research

Chart 26
Portugal: General Government deficit decomposition and public debt (% of GDP)



Source: Eurostat and BBVA Research

Box 3: United Kingdom: The worsening recession leads the Bank of England to attempt once again to intervene in order to spur lending in the economy

While economic indicators give no clear sign of a recovery, the elimination of certain adverse temporary factors that arose in the second quarter should buttress economic growth in the second half of the year, although not to an extent sufficient to avoid a slight contraction in GDP for the year overall. The external sector is feeling the effect of the worsening crisis in the eurozone, while private spending is unlikely to pick up, owing to the slow degearing process in the private sector. In light of this situation and owing to the lack of manoeuvring room for fiscal policy, the Bank of England, at its July meeting, unanimously decided to once again intervene in the financial market with measures to promote lending as well as to expand the quantitative easing programme. In fiscal matters, the first data on budget execution points to a slight improvement, although the target is not expected to be met.

Economic activity contracted sharply in the first half of the year, although this was the result of temporary factors

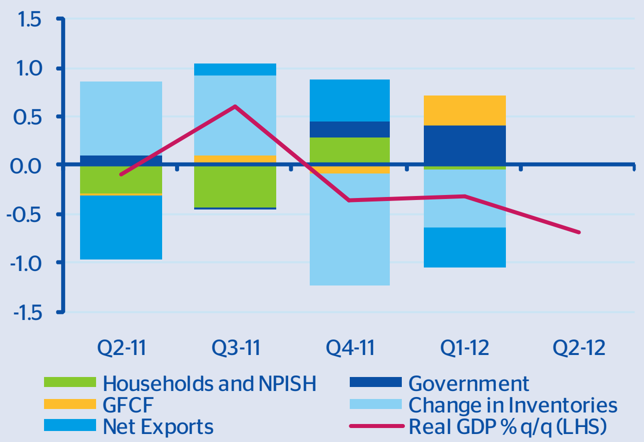
The British economy remained in a recession for the third consecutive quarter, as GDP declined sharply—and more than expected—in the second quarter (-0.7% q/q). This downturn is largely explained by the slump in the construction (-5.3% q/q) and the industrial sector (-1.3% q/q), while services remained practically stagnant (-0.1% q/q). This appears to corroborate the view that the current performance stems from temporary factors, such as adverse weather conditions and the smaller number of works days, and therefore suggests that economic activity should pick up in the second quarter of the year—even though there are practically no data available for the current quarter to confirm this. We should point out, however, that there are some drivers that could limit an economic upturn. First, the uptick in private consumption in the first half of the year does not appear to be sustainable, in light of the strong fiscal adjustment that has been announced. In addition, economic performance in coming quarters will be highly contingent on how the euro crisis plays out.

Consequently, we have lowered our overall growth forecasts for 2012 by 0.9pp, and we now expect to see a slight contraction in economic activity (-0.4%), following the 0.8% increase in 2011, which was driven by the external sector. Following the expected bounce in economic activity in the third quarter, growth rates should return to more normal levels in the remainder of the year and a modest recovery should be consolidated throughout 2013 (1.3%).

Labour market remains weak

Employment figures continue to send mixed signals. The unemployment rate based on the ILO criterion decreased to 8.1% after having remained at 8.3% over the last 2 months; however, applications for unemployment benefits continued to rise. In addition, wage increases were lacklustre, which means that real wages continued to fall. The reasons for the modest rise in wages include the wage freeze in the public sector and the sharp reduction in bonuses in the financial sector. The sluggish labour market along with heightened uncertainty might ultimately slow the pace of household deleveraging.

Chart 27
UK: GDP growth (% q/q) and contribution by components



Source: ONS and BBVA Research

Chart 28
UK: Labour market

Source: ILO, ONS and BBVA Research

The external sector loses steam

After having been the main driver of growth in 2011, in the first half of the year the external sector subtracted 0.4 percentage points from growth. In coming months, no noticeable improvement in exports' high degree of exposure to the eurozone is expected, because, although other markets are on the upswing, the slowdown in the global recovery will pose an additional risk. In addition, imports have been more buoyant than exports, partly because investment has remained stable. Consequently, exports are likely to continue to represent a drag on growth.

Inflation drops even further

Inflation has dropped at a steady pace thus far this year, and more quickly than expected, as a result of lower oil prices, as well as unusually aggressive end-of-season discounts. As a result, we have lowered our inflation forecast for this year from 2.9% to 2.5%.

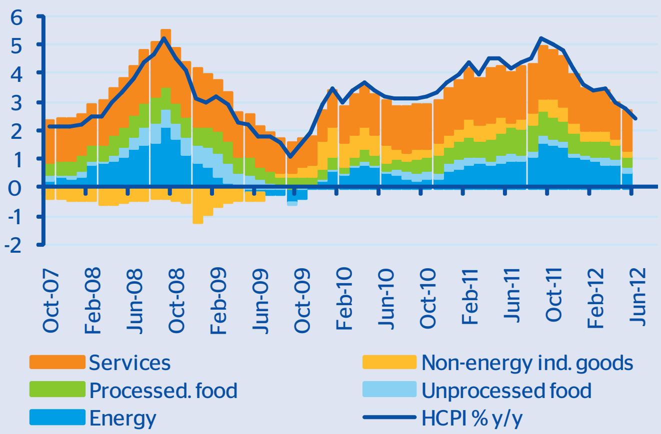
Bank of England intervenes once again, expanding quantitative easing

In response to the deterioration in economic activity and the recent aggravation of the eurozone's sovereign crisis, in-mid June the monetary authorities decided to intervene in the financial markets. First, by implementing a package of measures to promote lending through a reduction in bank financing costs. This will be achieved by providing funds over a long period and at a rate below the market rate. In exchange, financial entities are expected to boost financing for companies. Second, at the July meeting on monetary policy, committee members voted in favour of purchasing a further £50bn in assets as part of their quantitative easing strategy, bringing the total to £375bn (24% of GDP). Although the effectiveness of these measures thus far has been questioned, it is likely that for the remainder of the year the purchase programme will continue to be expanded, especially in light of the worsening recession and the lack of available demand-side policy tools. For now, we expect to see an increase of another £50bn between now and the end of the year and the maintenance of interest rates at their current levels at least until early 2014.

The budget execution improves, thanks to the transfer of pension fund

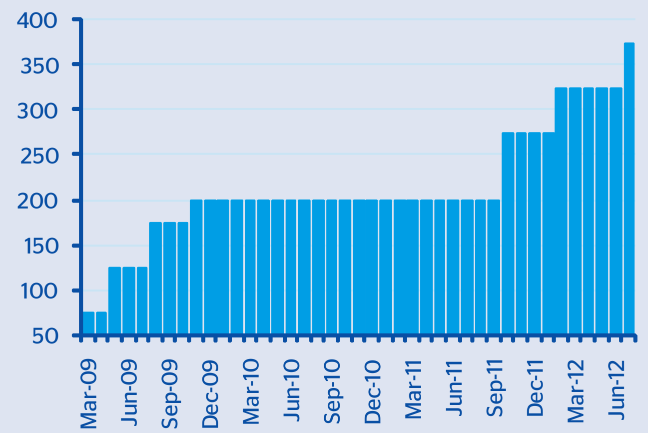
After closing the 2011-12 fiscal year with a deficit of 8.2%, the government aims to close the current year with a deficit of around 6.0%. To achieve this goal, the government made the transfer of the pension fund "Royal Mail" (£28bn pounds in April) and took a fiscally neutral package that aims to boost growth, and aims at simplifying the tax system and attract investment. The budget execution data of the current fiscal year to June shows a substantial improvement over the same period last year, although the weakness of the British economy raises questions about meeting the deficit target.

Chart 29
UK: Inflation



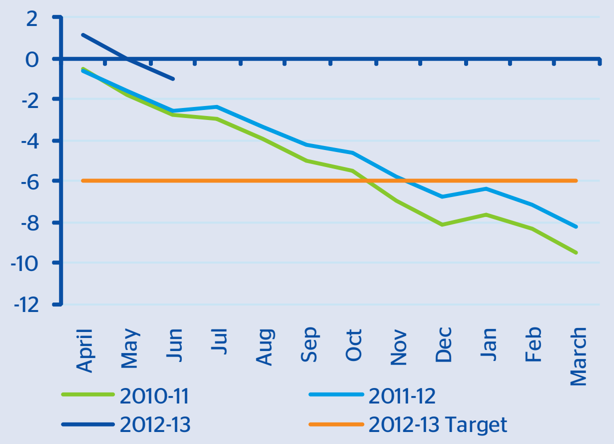
Source: ONS and BBVA Research

Chart 30
UK: Target Asset Repurchase Program (TARP)



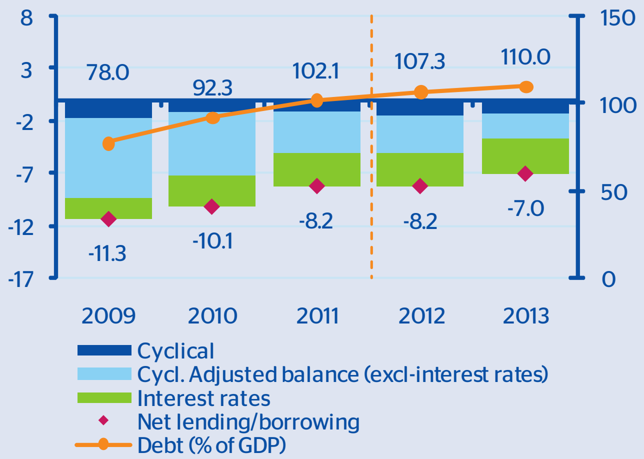
Source: ONS and BBVA Research

Chart 31
UK: Public sector net borrowing excluding financial interventions (% of GDP)



Source: ONS and BBVA Research

Chart 32
UK: Deficit decomposition and public debt (% of GDP)



Source: ONS, Government of the United Kingdom and BBVA Research

4. Tables

Table 3
Eurozone forecasts

(YoY)	2009	2010	2011	2012	2013
GDP at constant prices	-4.4	1.9	1.5	-0.3	0.3
Private consumption	-1.1	0.9	0.2	-0.6	0.0
Public consumption	2.6	0.7	-0.3	-0.4	-0.5
Gross Fixed Capital Formation	-12.4	-0.2	1.6	-2.9	-0.1
Inventories (*)	-0.9	0.6	0.2	-0.5	0.1
Domestic Demand (*)	-3.6	1.2	0.5	-1.5	0.0
Exports (goods and services)	-12.7	11.0	6.3	2.2	3.4
Imports (goods and services)	-11.4	9.4	4.1	-0.4	2.8
External Demand (*)	-0.8	0.7	1.0	1.1	0.4
Prices and Costs					
CPI	0.3	1.6	2.7	2.3	1.4
CPI Core	1.3	1.0	1.7	1.8	1.4
Labour Market					
Employment	-1.8	-0.5	0.3	-0.7	-0.2
Unemployment rate (% of labour force)	9.6	10.1	10.2	11.2	11.5
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-6.4	-6.2	-4.1	-3.1	-2.3
Public debt (% GDP)	79.6	85.5	87.3	89.1	89.4
External Sector					
Current Account Balance (% GDP)	-0.3	-0.1	0.0	0.9	1.4

(*) Contribution to GDP growth
Source: BBVA Research

Table 4
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.1	2.4	1.8	2.1	1.8
EMU	-4.4	1.9	1.5	-0.3	0.3
Germany	-5.1	3.6	3.1	0.9	1.4
France	-3.1	1.6	1.7	0.2	0.7
Italy	-5.5	1.8	0.5	-1.8	-0.1
Spain	-3.7	-0.1	0.7	-1.4	-1.4
UK	-4.0	1.8	0.8	-0.4	1.3
Latin America *	-0.6	6.6	4.5	2.9	3.8
Mexico	-6.1	5.4	4.0	3.7	3.0
EAGLES **	4.0	8.4	6.6	5.4	6.1
Turkey	-4.9	9.2	8.5	3.2	4.1
Asia Pacific	4.2	8.1	5.7	5.4	5.8
China	9.2	10.4	9.2	7.8	8.3
Asia (exc. China)	1.0	6.5	3.4	3.8	4.1
World	-0.6	5.1	3.9	3.4	3.7

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-0.4	1.6	3.1	2.0	1.9
EMU	0.3	1.6	2.7	2.3	1.4
Germany	0.2	1.2	2.5	2.0	1.4
France	0.1	1.7	2.3	2.3	1.5
Italy	0.8	1.6	2.9	3.3	1.9
Spain	-0.3	1.8	3.2	2.1	1.5
UK	2.2	3.3	4.5	2.5	2.0
Latin America *	10.6	8.5	9.1	10.1	8.9
Mexico	5.3	4.2	3.4	4.0	3.5
EAGLES **	2.8	5.3	6.0	4.3	4.4
Turkey	6.3	8.6	6.5	8.8	5.3
Asia Pacific	0.3	3.6	4.8	3.3	3.4
China	-0.8	3.3	5.4	3.0	3.6
Asia (exc. China)	1.1	3.8	4.3	3.4	3.2
World	2.2	3.8	5.1	4.2	3.9

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Current Account (% GDP)

	2009	2010	2011	2012	2013
United States	-2.7	-3.1	-3.1	-3.0	-3.1
EMU	-0.3	-0.1	0.0	0.9	1.4
Germany	5.9	6.1	5.8	5.4	5.5
France	-1.5	-1.7	-2.2	-1.9	-1.7
Italy	-2.0	-3.5	-3.2	-2.2	-1.7
Spain	-4.8	-4.5	-3.5	-1.2	0.7
UK	-1.7	-3.3	-1.9	-2.2	-1.3
Latin America *	-0.1	-0.9	-0.8	-1.6	-1.8
Mexico	-0.7	-0.3	-0.8	-1.3	-1.4
EAGLES **	2.6	1.6	0.9	0.5	0.4
Turkey	-2.3	-6.4	-10.0	-7.5	-7.4
Asia Pacific	3.5	3.3	1.8	1.4	1.6
China	5.2	4.0	2.8	2.5	2.8
Asia (exc. China)	2.3	2.0	1.1	0.7	0.9

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 7

Macroeconomic Forecasts: Government Deficit (% GDP)

	2009	2010	2011	2012	2013
United States	-9.9	-8.9	-8.7	-7.7	-5.0
EMU	-6.4	-6.2	-4.1	-3.1	-2.3
Germany	-3.2	-4.3	-1.0	-0.6	-0.5
France	-7.6	-7.1	-5.2	-4.6	-3.3
Italy	-5.4	-4.5	-3.8	-1.9	-0.9
Spain	-11.2	-9.3	-8.9	-6.3	-5.0
UK	-11.5	-10.1	-8.2	-8.4	-6.7
Latin America *	-3.1	-2.0	-2.1	-1.8	-1.1
Mexico	-2.6	-3.5	-3.0	-2.8	-2.8
EAGLES **	-3.8	-2.5	-2.3	-2.1	-1.9
Turkey	-5.5	-3.6	-1.4	-1.8	-1.6
Asia Pacific	-4.8	-3.6	-3.7	-3.7	-3.4
China	-2.8	-2.5	-1.1	-1.8	-1.8
Asia (exc. China)	-6.1	-4.5	-5.5	-4.9	-4.4

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 8

Financial Variables

Official Interest Rates (End period)	**2009**	**2010**	**2011**	**2012**	**2013**
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	0.75	0.75
China	5.31	5.81	6.56	5.75	6.00
10-year Interest Rates (Avg.)					
United States	3.2	3.2	2.8	1.8	2.5
EMU	3.3	2.8	2.6	1.6	2.5
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.72	0.76	0.72	0.79	0.77
EMU	1.39	1.33	1.39	1.27	1.30
UK	1.56	1.55	1.60	1.58	1.66
China (RMB per USD)	6.83	6.77	6.46	6.31	6.18

Forecast closing date: August 3, 2012
Source: BBVA Research

Table 9
Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	0.5	0.0	0.6	1.3	0.8	1.2
Public consumption	3.1	3.3	1.7	1.1	0.7	0.4
Gross Fixed Capital Formation	1.0	-11.4	5.2	6.6	0.3	3.3
Inventories (*)	0.0	-0.9	0.6	0.2	0.0	0.0
Domestic Demand (*)	**1.0**	**-2.3**	**2.2**	**2.4**	**0.6**	**1.4**
Export	2.1	-13.6	13.4	8.4	3.3	4.9
Import	3.0	-9.2	11.5	7.9	3.2	5.6
Net export (*)	**-0.2**	**-2.8**	**1.4**	**0.7**	**0.3**	**0.0**
GDP	**0.8**	**-5.1**	**3.6**	**3.1**	**0.9**	**1.4**
Inflation	**2.8**	**0.2**	**1.2**	**2.5**	**2.0**	**1.4**

(*) Contribution to growth
Source: BBVA Research

Table 10
France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	0.2	0.3	1.5	0.3	0.1	0.8
Public consumption	1.2	2.6	1.7	0.8	0.1	0.0
Gross Fixed Capital Formation	0.1	-10.4	1.0	2.6	0.0	1.4
Inventories (*)	0.3	-1.3	0.1	1.0	0.0	0.0
Domestic Demand (*)	**0.2**	**-2.6**	**1.6**	**1.7**	**0.1**	**0.7**
Export	-0.6	-11.8	9.2	4.6	2.5	4.1
Import	0.6	-9.5	8.4	5.3	2.1	3.6
Net export (*)	**-0.4**	**-0.5**	**0.0**	**0.0**	**0.1**	**0.1**
GDP	**-0.2**	**-3.1**	**1.6**	**1.7**	**0.2**	**0.7**
Inflation	**3.2**	**0.1**	**1.7**	**2.3**	**2.3**	**1.5**

(*) Contribution to growth
Source: BBVA Research

Table 11
Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-0.8	-1.6	1.2	0.2	-2.3	-0.6
Public consumption	0.6	0.8	-0.6	-0.9	-1.6	-1.0
Gross Fixed Capital Formation	-3.8	-11.7	1.7	-1.2	-7.9	0.2
Inventories (*)	0.0	-1.1	1.2	-0.6	0.0	0.0
Domestic Demand (*)	**-1.2**	**-4.3**	**2.1**	**-0.9**	**-3.3**	**-0.5**
Export	-2.8	-17.7	11.4	6.3	0.8	2.3
Import	-2.9	-13.6	12.4	1.0	-4.4	0.9
Net export (*)	**0.0**	**-1.2**	**-0.4**	**1.4**	**1.5**	**0.4**
GDP	**-1.2**	**-5.5**	**1.8**	**0.5**	**-1.8**	**-0.1**
Inflation	**3.5**	**0.8**	**1.6**	**2.9**	**3.3**	**1.9**

(*) Contribution to growth
Source: BBVA Research

Table 12

Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	1.3	-2.3	2.1	-4.0	-6.1	-1.4
Public consumption	0.3	4.7	0.9	-3.8	-2.6	-1.5
Gross Fixed Capital Formation	-0.3	-8.6	-4.1	-11.3	-9.6	-3.0
Inventories (*)	0.0	-1.1	0.1	-0.5	0.2	0.0
Domestic Demand (*)	**0.9**	**-3.6**	**0.9**	**-6.2**	**-6.0**	**-1.7**
Export	-0.1	-10.9	8.8	7.6	4.2	5.1
Import	2.3	-10.0	5.4	-5.3	-5.1	1.3
Net export (*)	**-1.0**	**0.6**	**0.5**	**4.6**	**3.5**	**1.4**
GDP	**-0.1**	**-2.9**	**1.4**	**-1.6**	**-2.6**	**-0.3**
Inflation	**2.7**	**-0.9**	**1.4**	**3.6**	**3.3**	**1.3**

(*) Contribution to growth
Source: BBVA Research

Table 13

Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-0.6	-4.3	0.8	-0.1	-2.0	-2.8
Public consumption	5.9	3.8	0.2	-2.2	-4.8	-4.1
Gross Fixed Capital Formation	-4.7	-16.5	-6.2	-5.1	-9.4	-5.6
Equipment and other products	-2.8	-22.0	5.3	1.5	-8.9	-4.4
Construction	-5.7	-15.4	-10.1	-8.1	-10.7	-6.7
Housing	-9.1	-22.0	-9.8	-4.9	-6.7	-8.3
Other construction	-1.6	-7.7	-10.4	-11.2	-14.6	-5.1
Inventories (*)	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand (*)	-0.5	-6.5	-1.0	-1.8	-4.2	-3.7
Export	**-1.0**	**-10.2**	**13.5**	**9.1**	**2.6**	**7.2**
Import	-5.1	-16.9	8.9	-0.1	-6.5	0.4
Net export (*)	1.4	2.8	0.9	2.5	2.8	2.2
GDP	**0.9**	**-3.7**	**-0.1**	**0.7**	**-1.4**	**-1.4**
Inflation	**4.1**	**-0.3**	**1.8**	**3.2**	**1.9**	**1.3**

(*) Contribution to growth
Source: BBVA Research

Table 14

UK: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-1.6	-3.1	1.3	-1.0	-0.2	1.5
Public consumption	1.6	0.8	0.4	0.1	2.0	-1.5
Gross Fixed Capital Formation	-4.6	-13.7	3.5	-1.4	2.0	5.6
Inventories (*)	-0.4	-1.0	0.9	0.4	-0.8	0.0
Domestic Demand (*)	**-1.9**	**-5.1**	**2.4**	**-0.4**	**-0.2**	**1.4**
Export	1.2	-8.2	6.4	4.4	1.1	2.5
Import	-1.8	-11.0	8.0	0.5	1.6	3.0
Net export (*)	**0.9**	**1.1**	**-0.6**	**1.2**	**-0.2**	**-0.2**
GDP	**-1.0**	**-4.0**	**1.8**	**0.8**	**-0.4**	**1.3**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.5**	**2.0**

(*) Contribution to growth
Source: BBVA Research

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