BBVA | RESEARCH

Europe Economic Outlook

First Quarter 2014
Economic Analysis

- **The slow recovery in the eurozone continues,** thanks to favourable economic policies and an improvement in the financial environment.
- **Global growth will continue to drive exports,** although these are less biased towards emerging economies.
- **Internal demand is showing signs of recovery,** and the peripheral countries have started to grow.
- **The AQR and stress test on the banking system together with single supervision in 2014** should help reduce financial fragmentation.
- **The ECB maintains a cautious stance on the recovery,** and appears to be prepared to take action to prevent deflation, which we in any case view as very unlikely.

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Closing date: February 7, 2014

1. Editorial

After a long recession lasting six quarters, since mid-2013 the eurozone has been on a recovery path. The factors that support the improved outlook for 2014 are little changed, albeit with some nuances: first, the external environment is more positive, with better perspectives than we forecast three months ago for the US, robust growth in the UK, uncertainties dispelled regarding growth in China (for which read the rest of Asia as well), and still strong growth in the emerging markets, with the exception of those subject to recent tensions. Second, slightly more benign financial conditions, particularly in the periphery, which has recently benefited from capital inflows and lower sovereign spreads. Third, a more favourable economic policy context than a year ago, with a less restrictive fiscal policy since Brussels changed its stance in May 2013, allowing deficit adjustment targets to be delayed and a more accommodative monetary policy, and above all, very cautious language on the part of the ECB regarding the recovery. Finally, progress towards banking union continues, and that paints a clearer picture of the eurozone's medium- and long-term perspectives. The agreements reached on the single resolution mechanism and the single resolution fund have not yet been approved by the European Parliament, and envisage only a slow transition towards a single resolution framework, but they are another step forward towards the SSM in December. This will come after an asset quality review and stress tests that should give rise to a transparent and recapitalised banking map by year-end. This is the most effective instrument for continuing to reduce the financial fragmentation that plagues the eurozone, as well as to foster new lending.

These factors should all help to ensure that the recovery continues in 2014, albeit at a moderate pace, given the still-present uncertainties and the high levels of both public- and private-sector leverage in many member states. Our growth forecast for 2014 remains unchanged at 1.1%, but accelerating to close to 2% in 2015, thus starting to close the big output gap in the eurozone, which should help to start to bring down the unemployment rate.

Although the key factors for our growth forecasts are essentially unchanged, the risk factors continue to evolve. In the external context, the advanced economies appear to be stronger, while uncertainties have materialised in some EMs, although the risk of widespread contagion appears to be small, as the markets continue to discriminate on the basis of each country's fundamentals. Within Europe, the risks associated with the periphery appear to be more contained, thanks to the improvement in financial conditions and improved confidence in these economies, partly because they have returned to positive growth. Portugal could return to the capital markets once its Troika programme is completed in May (although it is still not clear whether it will do so with a precautionary programme in place), Greece will soon be negotiating its exit from its first programme, probably with more favourable terms for its debt, while Italy is starting to introduce measures for political and public spending reforms.

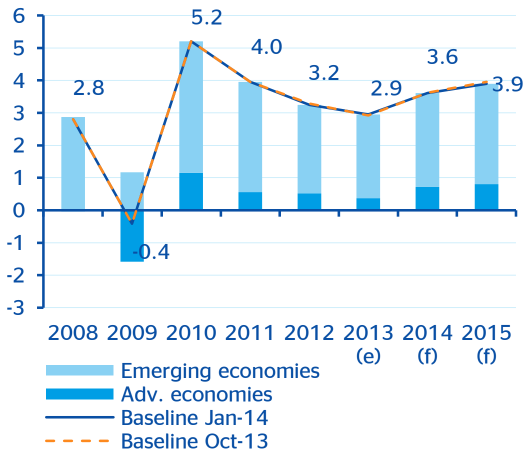
The new risk in the eurozone is deflation, in view of the fact that the headline rate has surprised to the downside on two occasions in the last few months. According to our estimates, the probability of deflation is low (less than 10%), and a detailed analysis of inflation dynamics indicates that the disinflationary trend was really in 2012 rather than 2013. At present inflation is very low, and is not helping peripheral countries to either increase competitiveness or deleverage. However, in a scenario of gradual recovery, inflation should increase slightly to 1% or marginally more in 2014. The main risk is that in an environment of low inflation and a still fragile recovery, a fresh negative shock could lead to negative inflation rates, with the risk of degeneration into a deflationary spiral. To avoid this, the ECB's role in anchoring expectations is crucial, as is that the central bank maintains or even reinforces its forward guidance policy in this context, and that if necessary it takes the already announced "decisive" action.

2. Global scenario: more growth in sight and with more balanced risks

The global economic cycle is improving and we now have clarity on some economic policy uncertainties

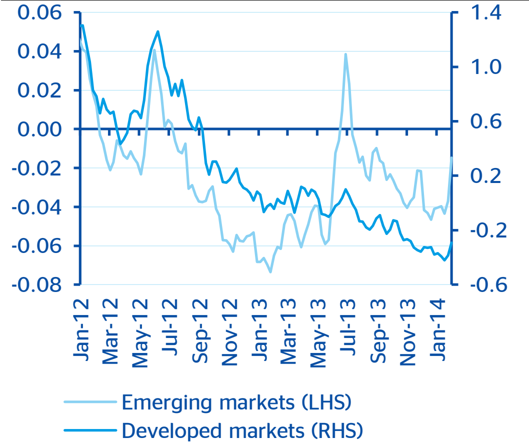
The global economic cycle strengthened during the latter months of 2013. According to our estimates, during the second half of 2013, global GDP accelerated to 1% QoQ, leaving behind the moderation with its roots in 2012 and its low at the beginning of 2013, when growth was barely 0.5%. This improvement was driven by the acceleration of the developed economies – particularly the US, but also the eurozone, which started to see moderate growth after the recession ended in mid-2013. In the EMs, the situation is more diverse, but some of them, such as China are posting relatively stable rates of growth.

Chart 2.1
Contributions to global economic growth (%)



Source: BBVA Research and IMF

Chart 2.2
BBVA Research Financial Tensions Index



Source: BBVA Research

Our assessment of the global scenario is better than it was three months ago, and this is reflected in the adjustments to our forecasts. Our projections now indicate that global GDP growth, which in 2013 had decelerated to 2.9%, will increase to 3.6% and 3.9% in 2014 and 2015, respectively (see Chart 2.1), practically the same as our forecasts three months ago, due to the offset between our growth expectations in the different areas: to the upside in the US, to the downside in some emerging economies and with no significant change in our forecasts for the eurozone as a whole in 2014. **In spite of the expected acceleration in growth, we still see some downside risks to our forecasts.** Although these risks are a long way from having the systemic nature that they had in the past, some recent events such as the fall in asset prices and currency depreciation in EMs have made themselves felt.

The US has reached sufficient cruising speed to start unwinding monetary stimulus

US GDP growth has been accelerating through 2013, and by year-end had already reached cruising speed, which allowed the Federal Reserve to take the first steps towards withdrawing monetary stimulus. In fact, growth in the third quarter accelerated to 1% QoQ, and the preliminary estimation pointed out that growth in the fourth quarter remained robust, although slightly below the third quarter.

There is more certainty regarding the tone of fiscal policy, which for 2014 implies less of a drag on economic growth. In December, an agreement was reached that represented an important step forward in eliminating the uncertainty regarding the funding of the government's activity in 2014-15, as well as reducing the fiscal adjustment initially forecast for that period. The direct effect of this reduction in the intensity of the fiscal consolidation alone raises our forecast growth for 2014 by a couple of tenths. Then there are also the potential effects, via confidence, that this reduced uncertainty could have on household consumption and corporate decisions regarding investment and hiring. Nonetheless, there are still issues outstanding that affect the long-term sustainability of the public accounts, such as healthcare spending and pensions.

The outlook for monetary policy has also clarified recently, in line with our expectations. The Fed had linked the end of its monetary stimulus programme to economic growth. As noted above, activity has tended to accelerate, while the unemployment rate fell to 6.7%. These developments took place in the context of an outlook for inflation well-anchored within the range determined by the Fed itself[1]. As a consequence, the Fed decided to start to taper its monthly purchases of assets such that by the fourth quarter of 2014, the central bank will have stopped expanding its balance sheet. Our base scenario also assumes that the first increase in interest rates will take place in the second half of 2015, although the Fed will continue to use its forward guidance to anchor interest-rate expectations.

In summary, we have revised upwards our forecast for US growth in 2014 to 2.5%, the same as our estimate for 2015. This adjustment reflects both the strength of the US economy in the second half of 2013 and the additional momentum contributed by the reduced fiscal drain thanks to the agreement reached at the end of last year. Note that there are also upside risks to our forecast if the improvement in confidence results in additional corporate investment and hiring.

Tapering could cloud the outlook for some emerging economies

The change of direction in US monetary policy has, as usual, had a global impact. The emerging economies are being subjected to capital outflows and currency depreciation, intensified in some cases by domestic events that have increased uncertainty regarding the management of their respective local economic policies. Even so, to date and from an aggregate perspective, the intensity of the non-resident capital outflows is no worse than on previous occasions when expectations have changed regarding the start of Fed tapering. In addition, there continues to be a differentiation between economies depending on their fundamentals: higher external deficits and more dependence on short-term and foreign-currency funding are associated with greater vulnerability to capital outflows and currency depreciation.

The recent tensions have not changed our growth forecasts for the EMs as a whole in our most likely scenario, but they do represent a significant downside risk.

Growth in China remains at around 7.5%, but the vulnerabilities are more evident

The fourth quarter was a clear example of the duality of China's economy as both a support for the global economy and a potential risk factor. The uncertainty at the beginning of the year regarding the sustainability of its growth and the possibility of a hard landing dissipated in the short term. The economy recovered in the second half of 2013 and maintains a good tone, although some of the more recent data on confidence and expectations of manufacturing activity are once again below expectations.

1: Inflation expectations on a one- to two-year horizon of no more than 0.5pp above the long-term target of 2%.

Fundamental changes in economic policy have also been announced. At the Third Plenum of the Chinese Communist Party, the authorities reiterated their commitment to maintaining high rates of growth, while at the same time proposing measures that will strengthen the role of the market in allocating resources and a rebalancing from a model based on investment and exports towards one of increasing household consumption. These announcements should be valued as steps in the right direction, but their effectiveness will depend on their execution, and they are not without risk.

Altogether, our 2014 and 2015 forecasts for China's economy remain unchanged, based on our confidence in the authorities' scope and ability to take action. All in all, the risk of a hard landing would be particularly damaging given the size of the economy and its importance for world trade.

3. Supporting drivers in recovery

As a whole, the European economy is behaving as expected, although with a change in the balance of risks

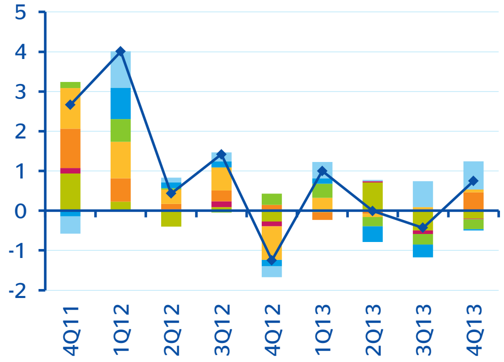
In general terms the Eurozone and its outlook for this year have not changed significantly from three months ago. 3Q growth was a little flatter than expected, with net exports that were relatively weak, but compensated by better internal demand than expected; this is welcome, since it may indicate that the recovery is going to be self-sustaining. 4Q13 indicators were as anticipated and confidence indicators suggest that recovery, while slow, is on track at the beginning of 2014.

This section looks at the factors supporting growth in the eurozone. Economic recovery policies are practically unchanged. Fiscal policy is less contractive than a year ago after Brussels changed direction in mid-2013. The ECB reduced interest rates in November and seems prepared to keep its monetary accommodation policy in place, prepared above all to respond to inflation risks. The banking union process continues to make progress and 2014 will be key in bringing more transparency to the European banking sector's situation, beginning to apply single supervision and reducing financial fragmentation. The external environment will remain an essential support to growth, with improvements in US forecasts, continued growth in China and the rest of Asia and Latin America, despite tensions in recent weeks in certain emerging countries. These tensions nevertheless represent a new source of downside risk, which compensates a noticeably more positive situation in eurozone internal risks, mainly issuing from peripheral countries, which have improved their forecasts. On the other hand, low inflation means that the risk of approaching deflation is, although far off, a new factor to bear in mind, which it appears the ECB is prepared to prevent.

Foreign growth continues thanks to exports, although with changes in the risks balance

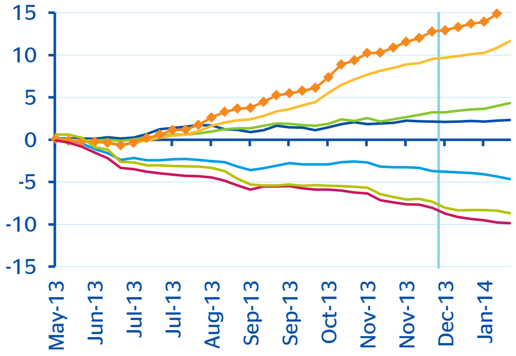
Our global forecasts have scarcely changed from three months ago, although obviously the source of growth is more skewed towards advanced countries, particularly the US, where we have revised upwards our growth forecast for this year by 0.2pp (see section 2). Outside the eurozone but still in Europe, the UK also seems to be enjoying the fruits of the stimulus policies of the last few years. In both the US and the UK the debate appears to be focusing now around whether to bring forward the tapering of stimuli from the commitment made in forward guidance policies, evidence of an improvement in the situation. Emerging markets will continue growing at a steady rate in the main, once the doubts about Chinese growth, which appeared in the first part of 2013, have been allayed. Chart 3.1 shows recent exports from the eurozone by destination, and the significance of the exports to other advanced economies.

Chart 3.1
EMU: exports (% QoQ) and contribution by areas



Source: Eurostat and BBVA Research

Chart 3.2
Capital flows: US, Europe and emerging countries (flows over total assets, accumulated)



Source: BBVA Research based on EPFR

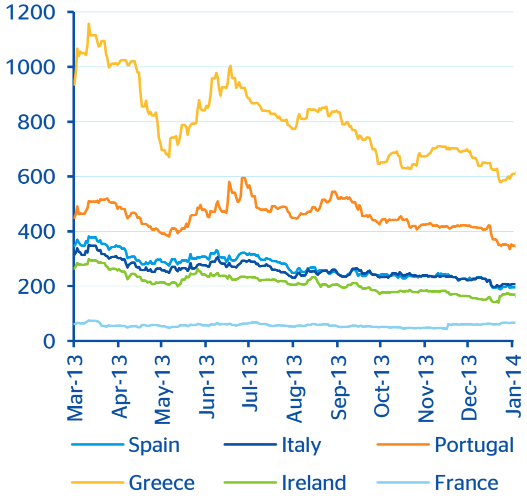
International financial conditions, influenced by US tapering and volatility in emerging countries

In the last few months, international financial markets have been led by two factors: the announcement of tapering, (reduction in asset purchasing), by the Federal Reserve and the increase in volatility in emerging markets. As to the first factor, the Fed announced in December the expected start of tapering. This reduced purchasing by USD10bn and we expect purchases to continue to be reduced at the same rate (provided that expected output levels are reached). Therefore, our scenario for the Fed's tapering has not changed: a gradual reduction of purchases, so that the programme of bond purchases should end by 4Q14. The Fed's communications policy has been more effective than it had been in previous months and, helped by external factors too, is succeeding in keeping expectations of interest rate rises anchored, and by that the long end of the interest rate curve as well.

When it comes to the second factor, risk perception of emerging economies has increased as a result of the beginning of tapering (synonymous with moderation in global liquidity); together with signs of cyclical slowdowns in these countries and, above all, due to the severe idiosyncratic shocks in some emerging markets. As was the case over the summer of 2013, this is leading to capital exit flows from emerging countries (see Chart 3.2).

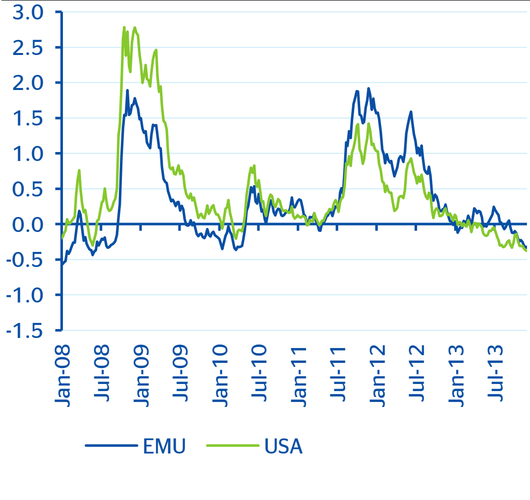
The combination of these two factors, added to cyclical weakness in Europe and growing expectations that the ECB will take action, have given rise to interest rates falling in the long sections of the European curve. In central European countries, the carry-over effect of American taxes, together with the reappearance of a degree of demand for safe-haven assets, keeps interest rates for German bonds below 1.70%. In peripheral countries, risk perception continues to flatten; in an environment of higher risk in emerging markets, this is favouring capital inflows into these countries and therefore putting downward pressure on interest rates (see Chart 3.3).

Chart 3.3
Risk premium (10Y spread) in the periphery



Source: Bloomberg

Chart 3.4
Financial Tensions Index, eurozone and US

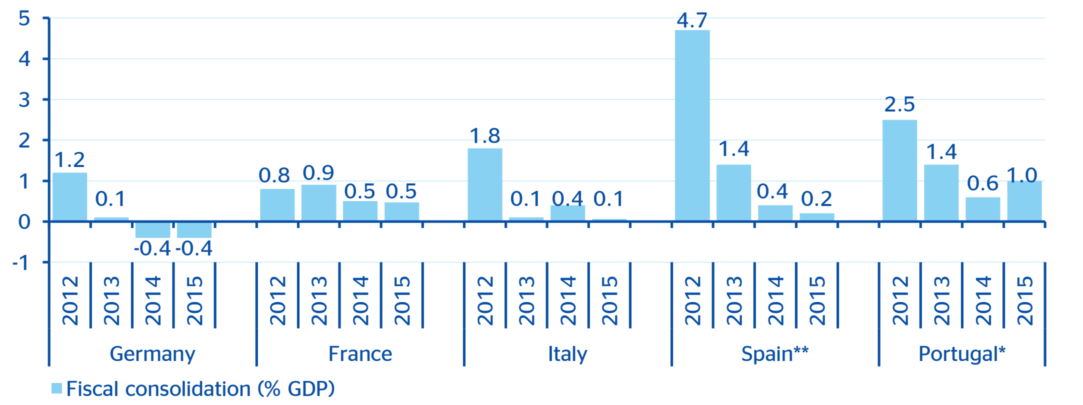


Source: BBVA Research

Accommodative monetary policy continues and the ECB is ready to take action

The ECB's surprising cut in its refinancing rate in November (from 0.50% to 0.25%, keeping the deposit rate at 0%) was a clear sign that the central bank is keeping its monetary policy openly lax. This followed its change of tack in the summer of 2013, when the concept of forward guidance was introduced and reinforced by the statements made by the bank's President, Mario Draghi, giving constant reminders of the fragility of the recovery. More recently, at its January meeting, the ECB made it clear that it is prepared to take more "decisive" measures in the face of two possible types of risks: tensions in financial markets and deflation (Box 1). As regards the latter, our central scenario is that inflation returning to around 1% in 2Q14, and over 1% later on, and that the risk of negative inflation is fairly low (a little under 10%), with deflation in the strict sense of the word even more unlikely (Box 2). The fact that, in addition, the ECB is prepared to prevent it, reduces its likelihood even more. In any event, it is true to say that inflation is currently well below the ECB's implicit target (below, but close to 2%) and that it will only return to those levels in 2016 according to our forecasts, meaning that adjustment in relative prices between the Eurozone periphery and the centre is more difficult to achieve.

Chart 3.5
Fiscal consolidation (% GDP)



* Portugal: one-off measures in 2012 & 2013 excluded
** Spain: not including aid to the financial sector
Source: BBVA Research

No substantial changes in fiscal policy since the moderate relaxation in mid-2013

Chart 3.5 shows the tone of fiscal policy in the Eurozone over the last few years and in the forecast period, defined (as is customary) as change in the structural primary deficit. The figures show that the budget adjustments in 2013 were less severe than in previous years, partly because they came in the wake of two years of harsh tightening, and partly because last May the European Commission lowered fiscal targets for several European countries, extending their deadline for reducing their public deficits to 3% by one or two years for countries in difficulties. This policy change not only led to a request for a smaller adjustment this year, but has implicitly caused some countries to subject their public finances to less pressure, which has in turn resulted in (small) deviations, yet to be established, over the new deficit targets, These factors have probably had a moderately expansive effect on growth compared to previous targets (although strictly speaking fiscal policy has continued to be restrictive because of the reduction in the primary structural deficit).

Progress towards banking union, asset quality reviews and stress tests will be key this year

Another of the factors which ought to contribute to steady growth are the reforms of European institutions, which have so far been limited to progress towards banking union, once the “Six-Pack” and the “Two-Pack” had been put in place, (with the initiatives for fiscal union having been indefinitely postponed). Of the four main areas – regulation, supervision, resolution and the deposit guarantee system – the first two are already underway, and in November of this year shared supervision will effectively begin, under the leadership of the ECB. The fourth area, which is the most complex, has been left pending for the medium to long term, while last December’s European summit took important steps in the third area, towards a single resolution mechanism and fund.

Before the single supervision mechanism (SSM) becomes fully operational, in 2014 asset quality reviews (AQRs) and stress tests will be conducted to establish the real state of the banks, to determine what one-off recapitalising needs specific institutions may have, to carry them out and to begin effective banking monitoring with a sound and transparent banking system which is subject to single supervision. This result will probably be the greatest effect that banking union will have in the short and medium term and will enable financial fragmentation to be significantly reduced between the central and peripheral countries, a necessary condition for monetary union to work in the medium and long term. The risks of this process not happening are considerable – the single resolution mechanism has yet to be approved by the European Parliament, which is still in negotiations with the European Council and the European Commission, the possibility of finding high recapitalisation needs in some banks are real, the possibility of contagion cannot be ruled out – but in general the most reasonable scenario is that the AQR exercise and stress test results should not result in huge surprises.

Risks continue to be to the downside and are now more connected to the external environment and less to peripheral countries

As well as the risks mentioned above about AQRs and deflation risks, covered in Box 2, the eurozone continues to be subjected to other downside risks which, although lower than six months or a year ago, have still not dissipated completely.

First, the situation outside Europe, which continues to be positive, has been slightly less so for a couple of months, due to the tense situation in some emerging countries, in general connected to their own economic or political fundamentals; however, for the moment there appears to be to be no contagion to other regions with better fundamentals. Forecast growth for China still seems to be robust, but were this not the case it would have a considerable impact on European exports.

When it comes to domestic risks, although the situation of the peripheral countries has improved significantly, it continues to be fragile. Growth has only just begun (after several quarters of recession, in some cases very deep), fiscal imbalances have not disappeared and public and private leveraging levels are still high. The situation, therefore, in the face of possible additional negative shocks, continues to be one of vulnerability. Portugal could probably exit its Troika aid programme by going to the markets, although the possibility of a second programme – this time of precautionary aid – has not been ruled out. Greece continues to have very high public debt (nearly all in the hands of the public sector now) which it will probably try to renegotiate before the middle of the year, now that it has achieved a primary surplus in its public accounts in 2013. Italy is immersed in negotiations to change its electoral system and ensure that its governments are more stable, as well as a programme to evaluate public expenditure which may give rise to reforms at some point, but it still suffers from very high public debt and political tensions. In any of these countries and in the rest of the eurozone, a return to recession would lead to a difficult situation, after the fiscal and economic fatigue of more than three years of budget austerity.

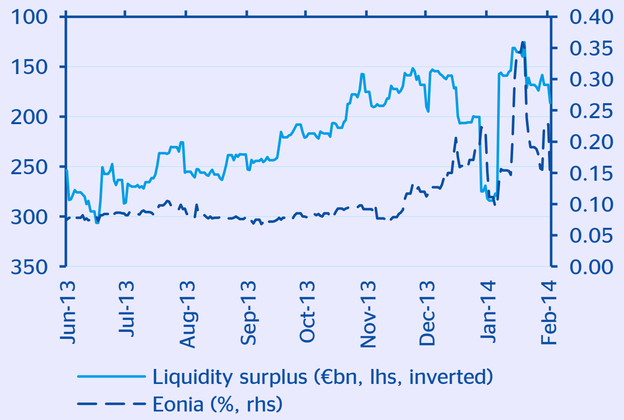
Box 1. ECB, the pressure is on to act

The ECB, after a surprising 25bp cut in the reference rate in November while leaving deposit rates at zero, has kept its policy unchanged, just as it has retained its downside bias to interest rates. This means that it is making no changes to any of the three fronts on which the monetary authority can act, whether intervention rates, non-standard policies, or on explicit changes to its forward guidance.

Nevertheless, the ECB has gradually modified its communications, trying to make its reaction function more explicit and facilitating the possibility of adopting additional accommodative measures.

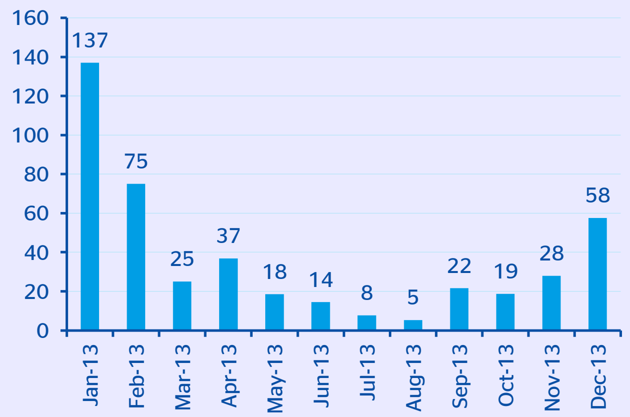
First, the ECB has specified two contingencies which could trigger action on its part: 1) unwanted tensions in the money markets, and 2) deterioration in the medium-term inflation outlook. This communiqué from the ECB comes in the context of a degree of tension and increased volatility in European financial markets. While we acknowledge that these events are to a large degree linked to the reduction of the excess liquidity in the system (as financial institutions accelerate the rate at which they repay the liquidity borrowed in the two LTROs (long-term refinancing operations) launched two years ago). Insofar as this is a voluntary move on the part of banks concerned, it can be read as the beginning of the normalisation of the financial markets. But, despite the fact that the repayments have taken place in a more favourable financing environment for European banks, we cannot rule out the possibility that this acceleration in repayments is linked to the AQR (Asset Quality Review). In any event, what we can say is that in the last quarter, while the ECB was reducing the intervention rate, money market rates have got tighter (see Charts B.1.1 and B.1.2).

Chart B.1.1
Excess liquidity in the Eurosystem in EUR bn (lhs, inverted) and Eonia fixing (ex month-end distortions) in % (rhs)



Source: Bloomberg y BBVA Research

Chart B.1.2
3Y LTROs repayment on a monthly basis (EUR bn)



Source: Bloomberg and BBVA Research

Second, when it comes to instruments, the ECB has emphasised that it is prepared to use all the instruments available under the EMU Treaty to deal with any of the two contingencies mentioned above. Much has been said in the past few months about the probability of the ECB intervening in its monetary policy (there is some scope for cutting the base rates and the possibility of taking the deposit rate into negative territory), or introduce new liquidity measures (whether by modifying the policy of sterilising bonds acquired under the Securities Markets Programme, launching some other kind of liquidity auction with slightly shorter timeframes or even beginning an asset purchasing programme, whether private- or public-sector). But there is still no clear option for action. The ECB itself acknowledges that there is no single instrument for dealing with all the risks considered, so that the choice of the instrument(s) will depend on the risk that it wishes to neutralise.

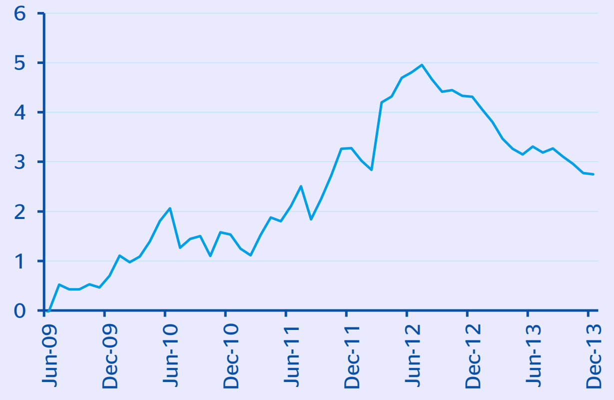
The option of explicitly reinforcing forward guidance has been less discussed by the ECB (at least in public) although, in our opinion, it is one of the instruments that could potentially be the most effective in the current situation. With rates close to zero and a still fragile recovery, the possibility of making monetary policy is significantly restricted. That is why the option of tying itself to lax policy in future becomes attractive, since it is a commitment that succeeds in anchoring rates in the present. Having said this, the risks of such a policy do not disappear: its implementation would restrict the ECB's scope of action in the medium term, even without the fact that a commitment of this nature runs the risk of being questioned and put to the test by the market.

Finally, there is a third issue in the ECB's recent communications strategy. The bank is also communicating that, should it be necessary, it will adopt decisive measures. This means that the monetary authority may be now more disposed to adopt a more aggressive strategy.

In our opinion, reducing interest rates (as already discounted by consensus), is not the optimum solution. The present environment is a combination of 1) a rapid reduction in liquidity as we approach the deadline for repaying the funds borrowed under the 3-year LTROs, 2) the AQR and stress test of the European banking system, 3) the persistence of a certain degree of fragmentation in the markets, and 4) inflation at levels well below the ECB target which implies the potential for deflation

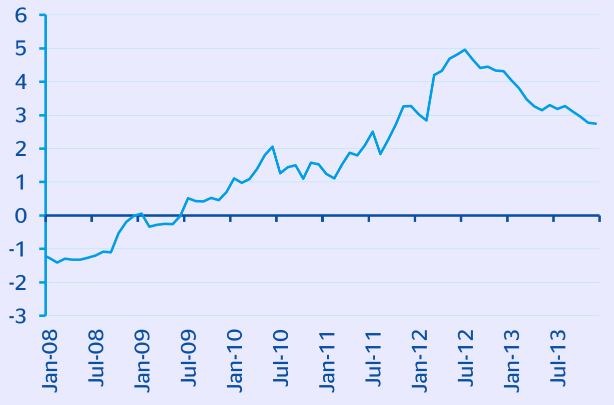
We believe the ECB will opt for a combination of measures. While the main central banks are anchoring their MPRs for a fixed period or tying them to the performance of certain variables such as inflation and unemployment (establishing thresholds), the ECB stance is less well defined. Thus we consider that the explicit reinforcement of its forward guidance could be a powerful tool in containing the present risks, particularly in an environment where financial fragmentation persists. To achieve this, besides the use of thresholds, one option for the ECB would be to support system liquidity at a fixed rate.

Chart B.1.3
Composite measure of eurozone financial fragmentation



Source: Bloomberg and BBVA Research

Chart B.1.4
Composite measure of eurozone financial fragmentation



Source: Bloomberg and BBVA Research

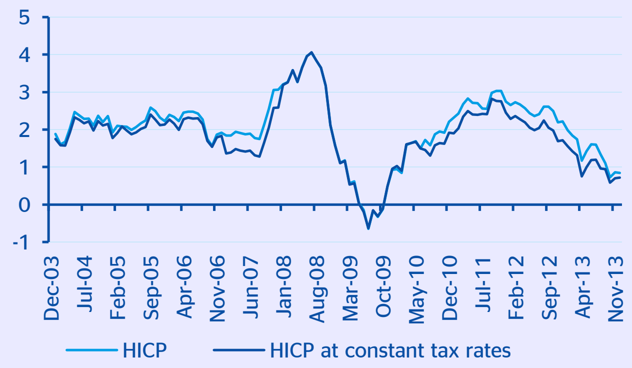
Box 2. Why are deflation risks in the eurozone limited?

Real disinflation is more of a 2012 phenomenon than a 2013 one

Inflation in the eurozone as a whole has decelerated rather more than expected over the last few months, which has generated concern about the speed and intensity of the disinflationary process in the area, while at the same time the margin for reaction to potential disruption in the economy has narrowed, which could lead to inflation at negative rates.

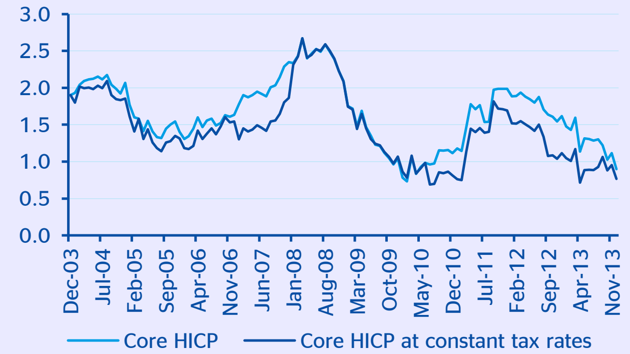
The recent slowdown in inflation does not appear to have been so much a response to a recent fall in internal demand – which has improved since 2Q13 – as to the disappearance of the effect of the tax rises that were part of the budget adjustments over the last few years. The price index adjusted by tax changes (published by Eurostat) makes it possible to evaluate this effect, and shows that the inflation rate (see Chart B2.1), calculated with this index was fluctuating around its current values (0.8% YoY) for the last year and a half, meaning that the slowdown of inflation was a reaction to the fall in internal demand at the beginning of the second recession at the end of 2011. We have extrapolated the impact of taxes on headline inflation on the core component (assuming that taxes had the same impact on all components' annual rates), and we have generated a core inflation series exempt from tax effects (see Chart B.2.2).

Chart B.2.1
EMU: inflation (% YoY)



Source: Eurostat and BBVA Research

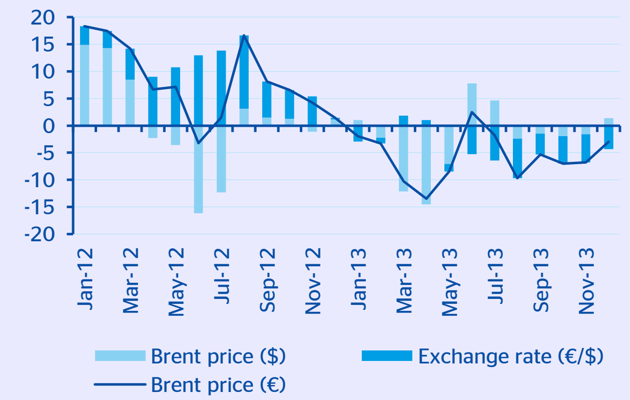
Chart B.2.2
EMU: core inflation (% YoY)



Source: Eurostat and BBVA Research

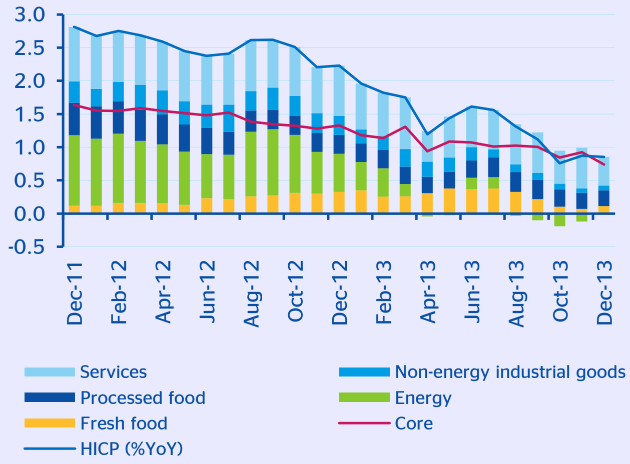
On the other hand, going back to the general harmonised price index, it also seems clear that most of the recent slowdown has been due to another base effect, this time energy prices, with falls in the second half of 2013, a result both of lower oil prices and of the appreciation of the Euro, after the strong increase observed a year earlier (above all due to the depreciation of the euro) (see Charts B.2.3 & B.2.4).

Chart B.2.3
Oil price and exchange rate (% YoY)



Source: Eurostat and BBVA Research

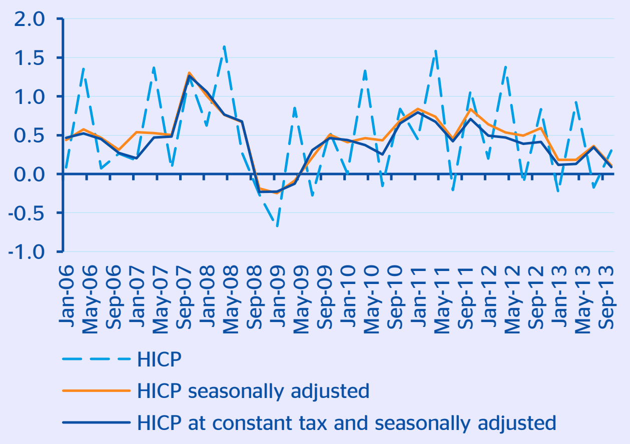
Chart B.2.4
EMU: inflation (% YoY) & contributions by components



Source: Eurostat and BBVA Research

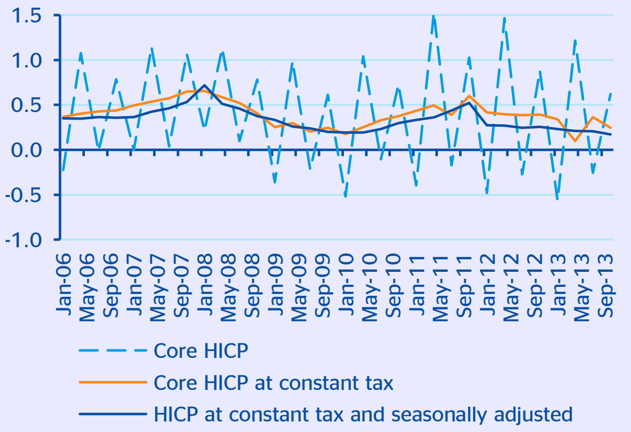
In an attempt to discount all these base effects, we have analysed the quarterly variations in prices once the series (with and without taxes) have been seasonally adjusted. This data again show that slowdown in inflation occurred principally from the end of 2011, due to the sharp fall in domestic demand. Core inflation net of taxes and energy prices fell brusquely at the beginning of 2012 and has slowed very smoothly since then, while headline inflation continued to fall until the end of 2012, and in 2013 has ended at similar levels to where it started (see Charts B.2.5 & B.2.6).

Chart B.2.5
EMU: Inflation (%, QoQ)



Source: Eurostat and BBVA Research

Chart B.2.6
EMU: Core inflation (% QoQ)



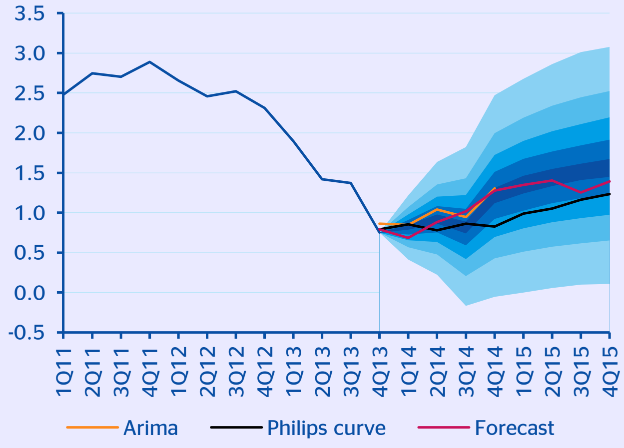
Source: Eurostat and BBVA Research

The slowdown of inflation was widespread among member states, mainly due to the fall in energy prices. Although a moderation in core inflation was noted, here the differences are more evident, being moderate in central European countries and more intense on the periphery, due mainly to the fact that the biggest tax rises occurred in these countries but also because of the structural reforms put in place in these latter countries, designed to gain competitiveness which have resulted in a reduction in the cost structure and, as such, given weak demand, in final prices. This situation is more than likely to continue in the horizon of the forecast, but contrasts with the situation in central European countries, particularly Germany, where the solid private spending together with pay rise requests – in a context of tight salary control during the crisis – could end up putting pressure to the upside on prices. Meanwhile, private consumption in France has remained relatively robust, which indicates that inflation will also stay stable, to accelerate a little during the horizon of this forecast. These two economies, which represent 47% of the eurozone as a whole, should guarantee that, although moderate, inflation in the eurozone remains far from the danger zone.

A scenario of progressive recovery in the eurozone should raise inflation from 2Q onwards.

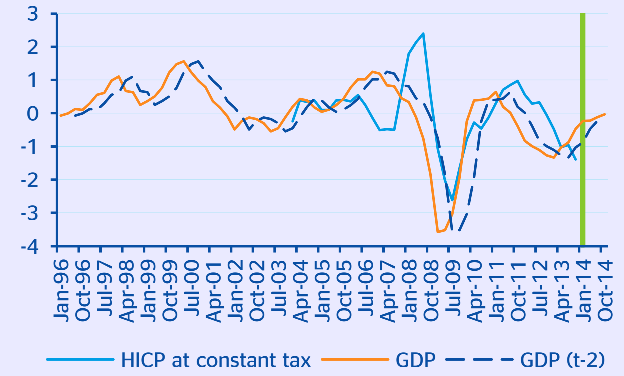
In the forecast horizon, doubts have not yet been entirely dispelled, relating in many cases to uncertainty about certain variables that are crucial in how pressure builds up on prices, since very often they cannot be observed. The relationship between price variation and different measures of output (GDP, output gap and changes in the output gap) employed in several of the models we use (Phillips curves, a version of the Smets and Wouters model[2] for the eurozone and models of temporary series) suggest on the whole that it seems unlikely that disinflation will stretch beyond 1Q14 (likelihood of less than 10% of registering negative inflation rates).

Chart B.2.7
EMU inflation (% YoY)



Source: Eurostat and BBVA Research based on Smets&Wouters model

Chart B.2.8
EMU: GDP and inflation (deviations from the mean)



Source: Eurostat and BBVA Research

Therefore, in our central scenario, with the ECB focused and prepared to intervene "decisively", in the words of its President Mario Draghi, it seems fairly improbable that a deflationary episode will occur. And even if an additional shock did affect the euro economy, negative inflation rates are a possibility, but not for long.

But what then might be the most dangerous trigger that could take the eurozone to deflationist territory? Without a doubt, and we think the ECB is aware of this, altered expectations as to price changes in the medium and long term, whether because price falls are anticipated, or because economic agents stop creating expectations in a rational manner and create them adaptively after a prolonged period of low inflation rates, as a result of a loss of credibility of the monetary authority fulfilling its target of price stability. Once inflation expectations settle into a situation of less inflation or deflation, the typical deflationary mechanisms may mean that negative inflation becomes a new equilibrium.

This scenario is unlikely as long as the ECB remains vigilant and prepared to react. Given the central bank's reluctance, in view of the uncertainty about non-standard measures, whether because of their impact or about withdrawing them, and bearing in mind that the probability of deflation is low, probably the most appropriate action is to give explicit support to the forward guidance policy, because of the importance of keeping inflation expectations anchored (see also Box 1).

2: Smets, F. and R. Wouters, "An estimated stochastic dynamic general equilibrium model of the euro area", ECB Working Paper Nº 171, August 2002

4. Perspectives for the eurozone at large

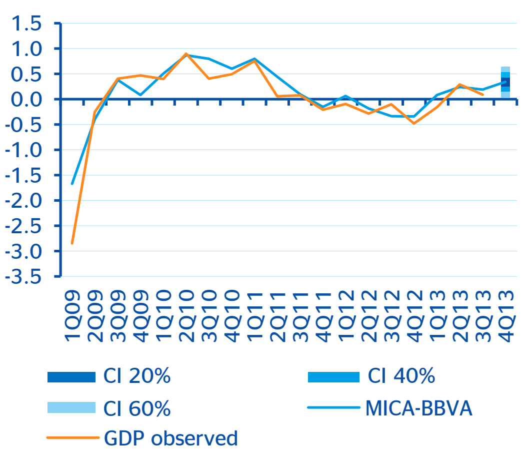
The recovery proceeds, with moderate growth in 2014 that will pick up in 2015

Over the last three months, economic indicators point to the eurozone recovery having gained some traction, the periphery included, both at the end of 2013 and at the beginning of this year. Confidence indicators improved considerably and lie around their historical mean (consistent with an average GDP growth of around 0.4% QoQ in the last quarter of 2013), while real indicators, particularly in November, point in the same direction, with domestic demand supporting growth and complementing the positive contribution of net exports.

Our MICA-BBVA short-term model[3] specifically estimates a quarterly GDP growth of around 0.3% to 0.4% QoQ in 4Q13 in the eurozone, after the 0.1% QoQ for 3Q13, and suggests that the pace of the recovery could remain relatively stable in 1Q14 (although the data are still very limited), which would lend an upward bias to the 0.3% QoQ forecast envisaged in our scenario. With this estimate for 4Q13, we stand by our forecast over the last six months of a eurozone GDP contraction of -0.4% for 2013.

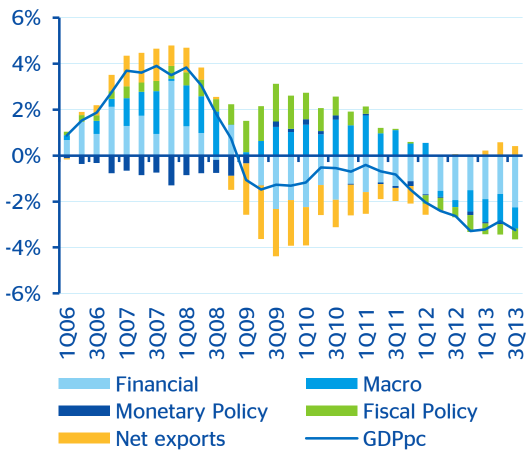
On a country-by-country basis, we expect Germany to have remained stable at around 0.3% QoQ in the last quarter of 2013 to grow 0.5% for the year, and the French economy to have made renewed progress (of around 0.2%) to end up growing a modest 0.2% last year. In the periphery, the pace of recovery gained momentum in Spain (0.3% QoQ after 0.1% QoQ in 3Q13), while Italy is likely to have recorded mild growth (0.1% QoQ). The latter notwithstanding, for 2013 overall, both the Spanish and Italian economies contracted considerably, by -1.2% and -1.8%, respectively.

Chart 4.1
Eurozone: MICA-BBVA and GDP observed (% QoQ)



Source: Eurostat and BBVA Research

Chart 4.2
EMU: breakdown of GDP by active population (cyclical component)



Source: BBVA Research

In general, economic performance at the end of 2013 came in line with our forecasts of the last quarters, partially reflecting that the management of the crisis in the eurozone at large was conducted in accordance with expectations (see Section 3). This performance was reflected by a cycle improvement which was assisted by the containment of financial stresses, together

3: For a detailed description of the model see the working paper entitled "The Euro-Sting revisited: PMI versus ESI to obtain euro area GDP forecast," available at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1120_tcm348-260444.pdf?ts=622013 with more accommodative policies (both fiscal and monetary) and an improvement in global demand[4] (see Chart 4.2).

Bearing in mind all of the above, our scenario continues to envisage that the dynamics previously observed in the second half of 2013 will consolidate in 2014, with domestic demand relieving exports over the course of 2014. We thus stand by our forecast of 1.1% growth for the eurozone. We now present, for the first time, our forecasts for 2015, which suggest that the economy will gain traction and grow by up to 1.9%, fundamentally driven by the rise in investment. These forecasts assume that the GDP level at the end of 2015 will have only reached pre-crisis levels (first quarter of 2008), with the output gap still in negative territory.

Eurozone growth will still be led by the German economy this year but, by 2015, we expect the growth of France and of the peripheral economies to converge to the rates recorded in Central European countries (see Chart 4.3)

The recovery of domestic demand will consolidate in 2014, with a gradual recovery of private consumption . . .

The sluggish correction and recovery of the determining factors of domestic demand over the last year were already reflected by the latter's gradual improvement beginning in 2Q13, although for the year overall its contribution to growth was negative (-0.9pp). This incipient recovery will consolidate over the course of 2014 (in which we expect its contribution to growth to come in at +0.8pp) and should gradually relieve net exports, to become the main engine of growth in 2015 (+1.7pp).

Private consumption, although moderate, will once again assist in expanding GDP within the forecasting horizon, the periphery included. The available indicators suggest that the sluggish growth it has recorded since 2Q13 is likely to continue until the end of the year. Consumer confidence increased significantly to reach its historical mean, supported by the stabilisation of the labour market over the last year (roughly 12%) and by improved expectations for the coming months. This is also being reflected by the moderate, but stable, growth of last year's retail sales, and suggests another rise in private consumption of around 0.1% QoQ for the last quarter of 2013.

For the forecasting horizon, the supporting factors for private consumption will continue to strengthen, given that the improved expectations for the labour market (job-creation short of 1% in 2015) will be reflected in a rise in compensation per employee within a context of low inflation (1% in 2014 and 1.4% in 2015). This will result in available household income remaining stagnant this year (as observed over the course of 2013) and rising by 2015 (0.6%), also supported by the gradual fall in the precautionary savings rate. All in all, after the 2013 contraction of -0.5%, private consumption should rise around 0.7% and 1.2% in 2014 and 2015, respectively. Nevertheless, this pace of growth is clearly less than those recorded prior to the crisis (an average of 2.3% over the 1995-2008 period), which suggests that household deleveraging and the still restrictive availability of credit will continue to weigh on consumer decisions.

… a surge in investment, particularly in 2015 . . .

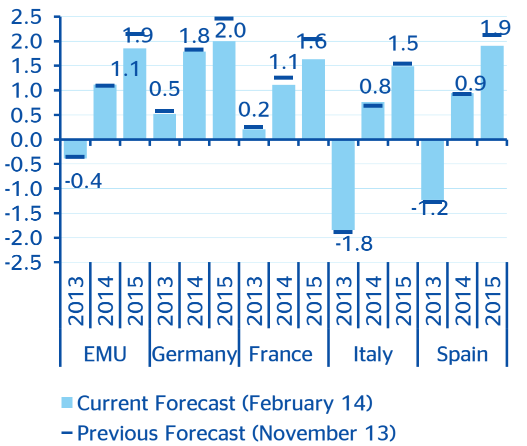
The gradual recovery of consumption notwithstanding, the support of global demand is still fundamental to drive investment which, together with easier credit, will lead to a significant rise in this component in 2015. Specifically, investment has already recorded moderate growth rates over the two mid-quarters of 2013, mainly in capital goods, which has benefited more from robust global demand, while the deterioration of investment in construction has moderated, and even recorded mild growth by 3Q13. The most recent indicators suggest that this trend should continue over the coming quarters (with significant rises in the

4: In accordance with our dynamic general equilibrium model. For a more detailed description of the model see Europe Economic Watch, "Bank lending and business cycle in EMU: a slow and fragile recovery," at: http://serviciodeestudios.bbva.com/KETD/fbin/mult/Europe_Economic_Watch_190711_tcm348-263401.pdf?ts=1122011 production of intermediate and capital goods and an improvement in orders), in spite of displaying certain weakness this year (1.6% after -3.1% in 2013, according to our forecasts), due to the still high uncertainty over the strength of future demand and tight lending terms. Nevertheless, to the extent that these terms continue to ease (with banking union on track and the conclusion of the AQR and stress test), and corporate profits continue to improve, and with capacity utilisation at historical levels, we expect a clear rebound in investment in 2015 (5%). This pick-up notwithstanding, the investment rate would still remain at historical lows at the end of the forecasting horizon (19%, around 3pp below the pre-crisis levels), after the sharp drop in investment recorded since 2008.

…and a mild recovery of public consumption

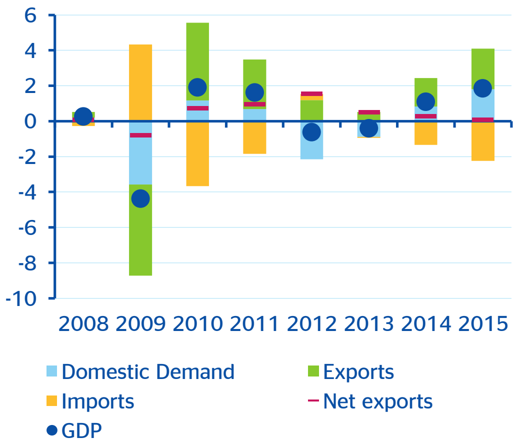
Finally, the slower pace of fiscal adjustment will also support growth within the forecasting horizon. The easing of fiscal targets in various member states in mid-2013 was partially the cause of the cyclical improvement of the economy, especially in the periphery, where the drag of public consumption disappeared or, at least moderated, together with the positive indirect effect it may have had on confidence. As a result, public consumption could have risen around 0.3% in 2013 in the eurozone as a whole, and we expect it to increase a little more in 2014 and 2015 (0.5% and 0.7%, respectively). This notwithstanding, fiscal policy will remain tight within the forecasting horizon, although the fiscal consolidation required to meet the structural balance target for public accounts will be less than in 2012 and 2013.

Chart 4.3
EMU: growth forecast by countries (%)



Source: BBVA Research

Chart 4.4
EMU: annual contribution to GDP growth (pp)



Source: Eurostat and BBVA Research

Net exports will lose relative importance over 2014, although foreign sales will continue to be robust and decisive for growth

Some of the factors behind the moderation of exports over 2013 were already dispelled at the end of the year, such as the temporary slowdown in global demand at the beginning of the year (which ended in global growth 0.3pp lower than in 2012, up to 2.9% in 2013), or the appreciation of the euro over the second half of the year (a nominal effective rate of around 5.3%), which was partially offset by low eurozone inflation via price differentials (4.4% in real terms). The most recent trade balance data suggest that exports (up to November) rose once again at the end of last year (0.7% in October - November over 3Q13), driven by sales to other European Union countries (2.3%) and Asia (2%). These figures are in line with our scenario, which anticipates relatively robust growth in exports (1% QoQ and 1.2% in 2013), outstripping imports (0.8% QoQ and 0.2%), given that domestic demand remains weak. Consequently, the positive contribution of net exports to quarterly GDP growth will resume in

4Q13 (0.1pp, after -0.4pp in 3Q13 and 0.5pp for 2013 as a whole). The foreign orders data available up to January indicate that this trend should continue over the coming months.

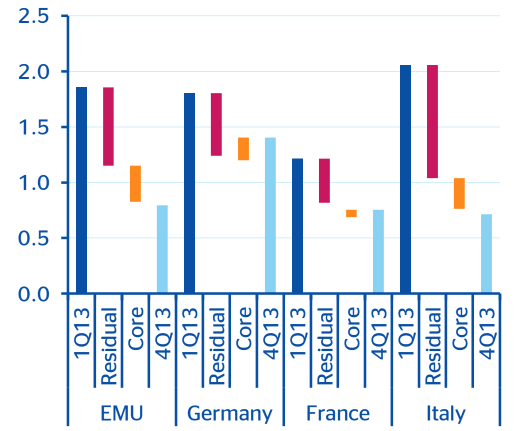
Within the forecasting horizon, exports should once again grow at a relatively strong pace (our forecast is for 3.5% in 2014 and 4.9% in 2015, vs. the average 6% growth between 1995 and 2008), supported by the pick-up in global growth, and in particular, among the EMU's main trading partners. Specifically, exports to non-eurozone European countries account for 46% of total exports, and are expected to grow over 2% within the forecasting horizon, while those destined for Asia (with an expected growth of just over 5%) account for 23%, and those to the Americas, where robust growth is expected, account for somewhat less than 20%. Another issue that ties into the latter is our expectation of euro depreciation over the coming quarters, together with the positive price differential, given the eurozone's low rates of inflation.

Dynamic exports will be decisive for the rise in investment, but the faster growth of imports will reduce the weight of the contribution of net exports to growth to 0.3pp and 0.2pp in 2014 and 2015, respectively, vs. the 0.5pp for 2013 (see Chart 4.4).

The stabilisation of the labour market will continue in 2014, with moderate job growth in 2015

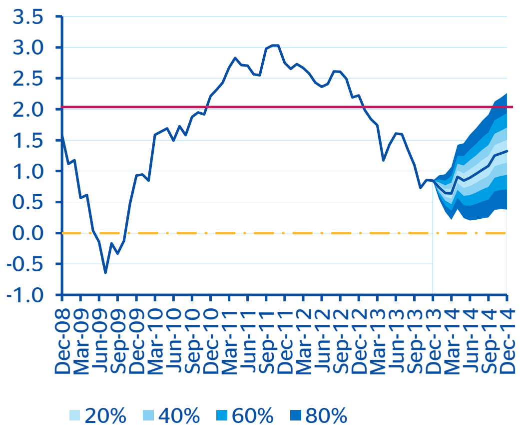
The stabilisation of the labour market over the last year (with the unemployment rate around 12%) has given more cause for optimism as the quarters have gone by. Thus, while in the first half of the year the stabilisation of the unemployment rate showed a drop in the active population which offset job destruction, employment in the second half may have remained stagnant or increased mildly (0.1% QoQ in 3Q13), although the improvement in expectations might have encouraged a part of the population to resume their search for employment, increasing the active population. Our scenario envisages that this trend will continue over the course of this year, with job and active population growth of around 0.1% each, and that it will be reflected by a relatively stable unemployment rate of 12% for the year as a whole after the 12.1% for 2013. For 2015, the pick-up in growth and domestic demand together with a significant reduction in uncertainty should encourage companies to hire workers, taking expectations of employment growth to 0.7% and a drop in the unemployment rate to 11.6%.

Chart 4.5
EMU: HICP inflation. Quarterly average (% YoY)



Source: Eurostat and BBVA Research

Chart 4.6
EMU: HICP inflation (% YoY)



Source: Eurostat and BBVA Research

Inflation will remain below the 1% level in the first half of 2014 and well below the ECB's target within the forecasting horizon

There was a significant, greater than expected slowdown in inflation in the last quarter of 2013 to 0.8% YoY, from the 1.3% YoY observed in 3Q13. The causes of this slowdown were the drop in energy commodity prices and the moderate inflation in perishable foods (both of which explain 0.3pp of the slowdown), but also a mild moderation in the price increases in services and non-perishable foods (which explain the remaining 0.2pp in equal proportions), placing underlying inflation at 1% YoY in 4Q13.

The moderation of prices that began at the end of 2012 continued throughout 2013, with both general and core inflation having remained relatively stable around 2.5% YoY and 2.3% YoY, respectively, in 2011 and most of 2012. This performance mainly reflects the disappearance of the base effects caused by the diverse tax increases implemented in various member states, mainly in the periphery, associated with the fiscal consolidation efforts in mid-2010 and 2011 (in Greece, Ireland, Italy, Portugal and Spain) and 2012 (Spain). Consequently, average annual inflation came in at 1.4% in 2013 (2.5% in 2012), with core inflation at 1.3% (vs. 1.8% in 2012).

If we discount the impact of the tax increases on prices in order to analyse their response to economic activity, we can see that both general and core inflation have been fluctuating around their current annual rates (0.9% YoY) since the second quarter of 2013 (see Box 2).

Thus, although we are revising significantly downwards our forecasts for headline and core inflation for this year to 1% and 0.9%, respectively (from the 1.4% and 1.2% of three months ago), given our scenario of growth and our assumptions regarding economic policy (an ECB that is ready to act and keep inflation expectations anchored), we believe that the disinflationary process will not extend beyond the first quarter of this year, with annual inflation rates possibly slowing by one- or two-tenths until March, after the 0.7% YoY forecast for January. Subsequently, we expect inflation to rise mildly in the second quarter and more markedly at the end of the year, to reach a rate of around 1.2% to 1.3% YoY. Thus the probability of recording negative inflation rates this year remains moderate at around 10%, although the risk attached to this scenario is still to the downside. For 2015, we expect both headline and core inflation to rise slightly to 1.4% and 1.2%, respectively.

Eurozone member states: detailed analysis

Germany: a strong recovery, supported by robust domestic and foreign factors

GDP: +0.5% in 2013, +1.8% in 2014, +2.0% in 2015

Recent data: after the GDP volatility at the end of 2012 and beginning of 2013 (-0.5% QoQ in 4Q12, 0% QoQ in 1Q13 and 0.7% QoQ in 2Q13), due to temporary factors, growth remained stable in 2H13 (BBVA Research: 0.3% QoQ in 4Q13 after 0.3% QoQ in 3Q13). The ongoing improvement of the labour market was reflected by a significant rise in disposable income and consumer confidence and suggests steady moderate growth rates in private consumption (although this conflicts with the less optimistic retail sales data). Furthermore, industrial production data for both intermediate and capital goods also suggest a consolidation of the increase in investment since 2Q13, also supported by overseas demand. This is in line with the balance of trade data, which revealed exports up to November (particularly those destined for the eurozone, the US and Asia) growing at a faster pace than imports, pointing to a new positive contribution from net exports. Over the last few months, confidence indicators surprised to the upside, especially manufacturing and export orders, coming in significantly higher than the historical average (average GDP growth: 0.4% QoQ), pointing to the recovery gaining traction in 1Q14 and implying upside risk of 0.4% QoQ to our growth forecast.

Outlook for 2013, 2014 and 2015: notwithstanding the moderation of growth in 2013 of up to 0.5% (0.9% in 2012), and discounting the above-mentioned temporary factors, the economy expanded at a robust pace and has already shown signs that the consolidation of both domestic and global demand is feeding through into investment. Increased global growth together with this year's expected euro depreciation should ensure that exports continue to grow at a robust pace within our forecast horizon. The latter, coupled with the growth in household spending, supported by good labour market conditions and moderate inflation, should be reflected in a rebound in investment, which is also favoured by expectations of low interest rates for an extended period.

Inflation: discounting the volatility in price trends due to changes in methodology, core inflation remained relatively stable at 1.5% YoY in 4Q13, while the headline rate slowed to 1.3% YoY (after remaining stable around 1.7% YoY earlier in the year), due mainly to the fall in energy prices. For the coming months, we expect inflation to remain relatively stable around the rate we forecast for January (1.2% YoY) and start to rise mildly in April, resulting in an average annual inflation rate of 1.5% in 2014 and 1.7% in 2015.

Fiscal policy: The latest budget execution data, available only for the federal government, suggest that the general government's fiscal balance recorded a mild surplus in 2013 (0.1% of GDP). The federal accounts recorded a deficit of EUR22.3bn (-0.8% of GDP) in 2013, roughly EUR3.1bn (-0.1% of GDP) below target. For 2014 and 2015, we expect the general government's fiscal accounts to once again record mild surpluses (0.2% and 0.3% of GDP, respectively). Additionally, debt should drop at an annual rate of 2.5pp to reach 74.5% of GDP in 2015.

France: the uncertainty continues and will be reflected in moderate growth over our forecast horizon

GDP: 0.2% in 2013, 1.1% in 2014 and 1.6% in 2015

Recent data: Economic performance has been very irregular since mid-2012, with alternating increases and contractions in activity that led to stagnant GDP over the last two years, with no clear signs of recovery. Nevertheless, we have observed somewhat more positive signs since the second quarter of 2013, particularly the rise in investment (machinery and transportation), while private consumption remained resistant and the delay in fiscal adjustment gave more support to public consumption. The most recent indicators point to renewed growth in private consumption and investment in 4Q13 (although the stagnation of retail sales is in contrast with the sharp rise in household spending), while industrial production data also suggest an improvement in activity. With respect to the foreign sector, the drop in exports seems to have moderated, while we expect a significant fall in imports. All in all, we expect the smaller negative contribution of net exports to partially offset the elimination of the significant contribution of inventories, in line with our scenario of 0.2% QoQ growth in 4Q13. Confidence indicators have displayed mixed signals in recent months, but appear to be improving with respect to the last quarter of 2013, such that we expect to see the recovery continue at a relative stable pace in the first quarter of 2014 (0.3% QoQ).

Outlook for 2013, 2014 and 2015: After the meagre growth we expected for 2013 (0.2%), our scenario envisages a consolidation of the signs of recovery observed in the last few quarters over the course of this year. The improvement of economic agents' confidence, also supported in part by reduced uncertainty over the situation in the eurozone at large, will be reflected by higher growth in private consumption and the recovery of investment. However, in contrast to the German economy, investment will benefit less from robust global demand, given that exports are still fundamentally oriented to other EU member states, with exports to Central Europe and the EMs carrying less weight. We therefore expect much more moderate growth of both exports and investment within our forecasting horizon. Finally, the support from public consumption will shrink in light of the implementation of a somewhat more restrictive fiscal policy aimed at meeting fiscal targets.

Inflation: After the slowdown observed at the end of 2012 and in the first quarter of 2013, both general and core inflation remained relatively stable, fluctuating around the 0.8% YoY level recorded at the end of 2013. VAT was increased in January of this year although by what seems to be a moderate amount and, given the weakness of demand, only a small portion is likely to be passed through to end prices. All things considered, we expect inflation to rise slightly and remain fluctuating around the 1% level for the rest of the year.

Fiscal policy: The latest government forecasts published last October showed a deficit of 4.1% of GDP for 2013, 0.4pp above target (-3.7% of GDP). The latest budget execution data should confirm this forecast. For 2014 and 2015, we expect the deficit to shrink to 3.6% and 2.9%, respectively. In 2015, the structural deficit should come in at 2% of GDP, entailing a fiscal consolidation of 2pp, after the -4% estimated for 2012. Debt should reach a high of 95.1% of GDP in 2014, dropping to 93.7% in 2015, after the 93.4% we expect for 2013.

Italy: slow emergence from recession, supported by foreign demand, to be boosted in 2015

GDP: -1.8% in 2013, +0.8% in 2014, +1.5% in 2015

Recent data: After eight quarters of recession, the fall in activity moderated over the first half of 2013 to stagnate in the third quarter. This performance was mainly supported by exports, but also by the lower burden of private consumption and investment. The available indicators already point toward mild growth in the fourth quarter. Industrial production displayed solid growth until November, while the rise in orders (including domestic) augurs the sustainability of the sector's recovery, and should continue to be reflected by the incipient rise in investment. Retail sales data suggest that household spending will remain very weak, although we do not envisage that it will get worse in spite of the slight deterioration of the labour market. Therefore, we expect growth for the last quarter of 2013 appears to have been underpinned by the positive contribution of the external sector, particularly due to the fall in imports, with exports showing certain signs of weakness, but with improved perspectives after the marked rebound of foreign orders. Finally, confidence indicators improved significantly over the last few months, especially in December, with PMIs pointing to more robust growth rates driven by the recovery of the industrial sector, which will benefit from global demand.

Outlook for 2013, 2014 and 2015: The slow emergence from recession resulted in a sharp contraction in 2013, but improved expectations of global demand and the consolidation of growth in the eurozone will support an export-driven recovery within our forecast horizon, also favoured by a moderate rise in domestic prices. Regarding domestic demand, our scenario is for both private consumption and investment to gradually improve over the coming quarters, although agent decision-making will remain weighed down by political uncertainty and adverse financing terms, notwithstanding the fact that progress toward banking union will gradually reduce financial market fragmentation. Finally, the fiscal adjustment will continue to weigh on growth, with another drop in public consumption in 2014.

Inflation: inflation stabilised around the 0.7% YoY mark over the last months of 2013, from relatively stable annual rates of roughly 1.3% for the two previous quarters. This trend in prices was mainly in response to the intensification of the fall in energy prices, while the slowdown in core inflation was much more moderate, down to around 1% YoY at the end of last year. These data show a moderate impact from the VAT increase in October, given the weakness of domestic demand. For the coming months, we expect an inflation rate around the current low levels, increasing slightly during the second half of the year, with an average annual inflation rate of 0.8% and 1.2% in 2014 and 2015, respectively.

Fiscal policy: The most recent budget execution data show a deficit above the 3% target. However, after excluding non-recurrent expenses, which are not included in the excessive deficit procedure (payment of government debts and the stake in the capital increase in favour of the European Investment Bank, among others), the deficit could eventually end up around the 3% target. We expect the deficit to continue shrinking in 2014 and 2015, to -2.5% and -1.9% of GDP, respectively. The 2013 adjustment of the structural deficit will be around half a point of GDP if the 3% target is finally met, which means that the required fiscal consolidation to achieve structural balance would remain at 1.5% of GDP**.** Furthermore, in 2013 debt would reach 133.2% of GDP, would remain practically stable in 2014, and should decline to 131.5% in 2015.

Spain: 2013 was the year of transition toward a new expansion cycle

GDP: -1.2% in 2013, +0.9% in 2014, +1.9% in 2015

Recent data: The Spanish economy recorded two sequential quarters of positive growth in activity in the second half of 2013, and will close the fourth quarter with a GDP growth of roughly 0.3% QoQ. However, this change in trend was not enough to prevent a contraction in GDP of 1.2% in 2013 as a whole. The contraction in activity was entirely due to the drop in domestic demand, in spite of having returned into expansionary territory in the second half. On the other hand, net foreign demand would seem to have once again cushioned the deterioration, in spite of the temporary correction to the downside observed at the end of the year. With respect to the first quarter of 2014, the information available suggests continuity in the expansionary tone of activity (MICA-BBVA between 0.3% QoQ and 0.5% QoQ).

Outlook for 2013, 2014 and 2015: The improvement in the fundamentals of the Spanish economy warrants a consolidation of the recovery over the course of the next two years. We expect activity to grow roughly 0.9% in 2014 and to surge to up to 1.9% in 2015, rates of growth that will be sufficient to sustainably create jobs for the first time since the beginning of the crisis, but which will not allow a significant reduction of the unemployment rate. Stronger global growth, and in the eurozone in particular, together with the geographical diversification and the depreciation of the real effective exchange rate (supported by internal devaluation and accommodative monetary policy in Europe), will reinforce the positive differential trend of Spanish exports. At a domestic level, we expect a less contractive fiscal policy tone than the one observed in 2013 and, particularly, in 2012. Furthermore, the recovery of domestic demand will be supported by the restoration of confidence, the recovery of employment, the drop in borrowing costs, the pull effect of exports and, lastly, the advanced stage of some internal adjustment processes.

Inflation: The closing data for 2013 confirm that the surge in consumer prices observed at the start of the fiscal year was not in response to domestic market inflationary pressures, but rather to factors exogenous to demand, such as the increase in VAT and in some regulated prices in the fall of 2012. Once these factors vanished, both headline and core inflation slowed quickly in the second half of the year, to reach levels around 0.3% YoY and 0.2% YoY in December (1.4% YoY on average for 2013 in both cases). For the forecasting horizon, we expect inflation to continue at subdued levels (0.5% in 2014 and 1% in 2015).

Fiscal policy: Although we expect the fiscal adjustment to have continued over 4Q13, it is likely to be insufficient to correct the negative effects of the drop in activity in past quarters on revenues, and the expected rise in both interest payments and welfare benefits (excluding unemployment benefits). We estimate a 2013 deficit of around 7% of GDP, almost half a point above target (6.5%). Nevertheless, the positive effects of the recovery together with the impact of the adjustment measures over these years should result in the 2014 deficit, excluding financial sector aid, coming in at around 5.8% of GDP, in line with target. In 2015, in a scenario without fiscal policy changes, the deficit would remain around 5% of GDP, above the -4.2% agreed for that year.

5. Tables

Table 5.1
Eurozone forecasts (% YoY)

	2011	2012	2013	2014	2015
GDP at constant prices	**1.6**	**-0.6**	**-0.4**	**1.1**	**1.9**
Private consumption	0.3	-1.4	-0.5	0.7	1.2
Public consumption	-0.1	-0.5	0.3	0.5	0.7
Gross Fixed Capital Formation	1.8	-3.9	-3.1	1.6	5.0
Inventories (*)	0.2	-0.5	-0.1	0.0	0.0
Domestic Demand (*)	**0.7**	**-2.1**	**-0.9**	**0.8**	**1.7**
Exports (goods and services)	6.7	2.7	1.2	3.5	4.9
Imports (goods and services)	4.7	-0.8	0.2	3.3	5.1
External Demand (*)	**0.9**	**1.5**	**0.5**	**0.3**	**0.2**
Prices and Costs					
CPI	2.7	2.5	1.4	1.0	1.4
CPI Core	1.7	1.8	1.3	0.9	1.2
Labour Market					
Employment	0.3	-0.7	-0.8	0.1	0.7
Unemployment rate (% of labour force)	10.2	11.4	12.1	12.0	11.6
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-4.1	-3.7	-2.8	-2.4	-2.1
Public debt (% GDP)	88.2	93.0	95.6	96.1	95.7
External Sector					
Current Account Balance (% GDP)	0.1	1.2	2.1	2.1	2.0

(*) Contribution to GDP growth
Source: BBVA Research

Table 5.2
Macroeconomic forecasts: GDP growth (% YoY)

	2011	2012	2013	2014	2015
United States	1.8	2.8	1.8	2.5	2.5
Eurozone	1.6	-0.6	-0.4	1.1	1.9
Germany	3.4	0.9	0.5	1.8	2.0
France	2.0	0.0	0.2	1.1	1.6
Italy	0.6	-2.6	-1.8	0.8	1.5
Spain	0.1	-1.6	-1.2	0.9	1.9
UK	1.1	0.3	1.9	2.6	2.4
Latin America *	4.0	2.6	2.2	2.5	2.6
Mexico	4.0	3.7	1.2	3.4	3.0
Brazil	2.7	1.0	2.2	2.5	1.9
EAGLES **	6.7	5.0	4.8	5.2	5.4
Turkey	8.5	2.4	3.9	1.5	5.2
Asia Pacific	6.0	5.3	5.2	5.3	5.4
Japan	-0.4	1.4	1.7	1.5	1.3
China	9.3	7.7	7.7	7.6	7.5
Asia (exc. China)	3.7	3.5	3.4	3.7	4.0
World	4.0	3.2	2.9	3.6	3.9

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: 7 February, 2014
Source: BBVA Research

Table 5.3
Macroeconomic forecasts: Inflation (Avg.) (% YoY)

	2011	2012	2013	2014	2015
United States	3.1	2.1	1.5	2.3	2.4
Eurozone	2.7	2.5	1.4	1.0	1.4
Germany	2.5	2.1	1.6	1.5	1.7
France	2.3	2.2	1.0	1.0	1.2
Italy	2.9	3.3	1.3	0.8	1.2
Spain	3.2	2.4	1.4	0.5	1.0
UK	4.5	2.8	2.6	1.9	2.0
Latin America *	8.0	7.5	8.9	11.6	10.7
Mexico	3.4	4.1	3.8	4.3	3.4
Brazil	6.6	5.4	6.2	6.1	5.6
EAGLES **	6.0	4.2	4.2	4.4	4.2
Turkey	6.2	8.7	7.6	8.2	5.3
Asia Pacific	4.9	3.1	2.9	3.5	3.5
Japan	-0.3	0.0	0.3	2.1	1.5
China	5.4	2.6	2.6	3.3	3.5
Asia (exc. China)	4.5	3.4	3.1	3.7	3.6
World	5.1	4.1	3.8	4.1	4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Korea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Forecast closing date: 7 February, 2014
Source: BBVA Research

Table 5.4
Macroeconomic forecasts: Current account (% GDP)

	2011	2012	2013	2014	2015
United States	-3.0	-2.7	-2.5	-2.5	-2.1
Eurozone	0.1	1.2	2.1	2.1	2.0
Germany	5.7	7.0	7.0	6.1	6.5
France	-2.0	-2.3	-1.7	-1.8	-1.7
Italy	-3.1	-0.7	0.7	1.0	0.8
Spain	-3.8	-1.1	0.9	1.6	1.7
UK	-1.6	-4.6	-3.6	-2.8	-2.3
Latin America *	-0.9	-1.5	-2.2	-2.1	-2.0
Mexico	-0.9	-1.0	-1.3	-1.5	-1.6
Brazil	-2.1	-2.4	-3.6	-3.4	-3.2
EAGLES **	0.5	0.2	0.3	0.4	0.6
Turkey	-9.9	-6.9	-7.4	-5.8	-6.3
Asia Pacific	1.5	0.9	1.2	1.4	1.7
Japan	2.0	1.0	1.2	1.5	2.0
China	1.9	2.3	2.3	2.5	3.0
Asia (exc. China)	1.3	0.0	0.5	0.6	0.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: 7 February, 2014
Source: BBVA Research

Table 5.5
Macroeconomic forecasts: Government deficit (% GDP)

	2011	2012	2013	2014	2015
United States	-8.7	-6.8	-4.2	-3.4	-2.2
Eurozone	-4.1	-3.7	-2.8	-2.4	-2.1
Germany	-0.8	0.2	0.1	0.2	0.3
France	-5.3	-4.8	-4.1	-3.6	-2.9
Italy	-3.8	-2.8	-3.3	-2.5	-1.9
Spain *	-9.1	-6.8	-7.0	-5.8	-5.1
UK	-7.8	-6.3	-5.7	-5.8	-4.5
Latin America **	-2.3	-2.5	-2.7	-3.8	-2.9
Mexico	-2.7	-3.2	-2.9	-4.1	-3.6
Brazil	-2.6	-2.5	-3.2	-3.9	-3.2
EAGLES ****	-1.9	-2.3	-2.2	-2.4	-2.3
Turkey	-1.4	-2.1	-1.2	-2.2	-1.6
Asia Pacific	-3.7	-3.7	-3.7	-3.4	-3.2
Japan	-10.0	-9.5	-10.0	-8.5	-8.0
China	-1.1	-2.1	-1.9	-2.5	-2.5
Asia (exc. China)	-5.4	-4.8	-4.8	-4.0	-3.7

* Excluding aid to financial sector
** Fiscal year from 1 April to 31 March
*** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
**** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: 7 February, 2014
Source: BBVA Research

Table 5.6
Financial variables

Official interest rates (end-period) (%)	2011	2012	2013	2014	2015
United States	0.25	0.25	0.25	0.25	0.50
EMU	1.00	0.75	0.25	0.25	0.50
China	6.56	5.75	6.00	6.00	6.50
10-year interest rates (avg.)(%)					
United States	2.8	1.8	2.3	3.2	3.7
EMU	2.6	1.6	1.6	2.0	2.5
Exchange rates (avg.)					
(US Dollar per national currency)	0.72	0.78	0.75	0.77	0.75
United States (EUR per USD)	1.39	1.29	1.33	1.30	1.33
EMU	1.60	1.59	1.56	1.57	1.62
UK	79.7	79.8	97.6	110.0	117.1
Japan	6.46	6.31	6.20	5.97	5.85

Forecast closing date: 7 February, 2014
Source: BBVA Research

Table 5.7
Germany: GDP growth and inflation forecasts (% YoY)

	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	0.7	0.3	1.0	2.3	0.7	1.1	1.4	1.6
Public consumption	3.2	3.0	1.3	1.0	1.0	0.5	1.0	0.9
Gross Fixed Capital Formation	0.6	-11.6	5.2	7.1	-1.3	-0.5	4.5	5.1
Inventories (*)	-0.1	-0.7	0.5	-0.1	-0.6	0.0	0.0	0.0
Domestic Demand (*)	**0.9**	**-2.0**	**2.2**	**2.7**	**-0.2**	**0.7**	**1.8**	**2.0**
Exports	2.3	-13.0	14.8	8.1	3.8	0.5	3.9	4.3
Imports	3.0	-7.8	12.3	7.5	1.8	0.9	4.5	4.9
Net exports (*)	**-0.1**	**-3.0**	**1.7**	**0.7**	**1.1**	**-0.2**	**0.0**	**0.0**
GDP	**0.8**	**-5.1**	**3.9**	**3.4**	**0.9**	**0.5**	**1.8**	**2.0**
Inflation	**2.8**	**0.2**	**1.2**	**2.5**	**2.1**	**1.6**	**1.5**	**1.7**

(*) Contribution to growth
Source: BBVA Research

Table 5.8
France: GDP growth and inflation forecasts (% YoY)

	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	0.2	0.4	1.5	0.5	-0.3	0.3	0.9	1.2
Public consumption	1.2	2.6	1.8	0.5	1.4	1.7	0.6	0.6
Gross Fixed Capital Formation	0.1	-10.4	1.2	3.0	-1.2	-2.3	1.8	2.5
Inventories (*)	0.3	-1.3	0.2	1.1	-0.8	0.0	0.0	0.0
Domestic Demand (*)	**0.1**	**-2.6**	**1.8**	**2.1**	**-0.9**	**0.2**	**1.1**	**1.4**
Exports	-0.6	-11.9	9.0	5.6	2.5	0.6	2.2	3.8
Imports	0.6	-9.5	8.6	5.3	-0.9	0.7	1.9	2.8
Net exports (*)	**-0.3**	**-0.5**	**-0.1**	**0.0**	**1.0**	**0.0**	**0.1**	**0.2**
GDP	**-0.2**	**-3.1**	**1.6**	**2.0**	**0.0**	**0.2**	**1.1**	**1.6**
Inflation	**3.2**	**0.1**	**1.7**	**2.3**	**2.2**	**1.0**	**1.0**	**1.2**

(*) Contribution to growth
Source: BBVA Research

Table 5.9
Italy: GDP growth and inflation forecasts (% YoY)

	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-0.8	-1.6	1.5	-0.3	-4.2	-2.5	0.1	1.2
Public consumption	0.6	0.8	-0.4	-1.1	-2.6	-0.3	-0.5	0.5
Gross Fixed Capital Formation	-3.8	-11.8	0.5	-1.6	-8.4	-5.7	0.7	2.2
Inventories (*)	0.0	-1.1	1.1	-0.1	-0.6	-0.1	0.0	0.0
Domestic Demand (*)	**-1.2**	**-4.3**	**2.1**	**-0.8**	**-5.2**	**-2.7**	**0.1**	**1.3**
Exports	-2.8	-17.7	11.2	6.9	1.9	0.1	3.6	4.1
Imports	-2.9	-13.6	12.3	1.4	-7.5	-3.2	1.6	3.9
Net exports (*)	**0.0**	**-1.2**	**-0.4**	**1.5**	**2.7**	**0.9**	**0.7**	**0.2**
GDP	**-1.2**	**-5.5**	**1.7**	**0.6**	**-2.6**	**-1.8**	**0.8**	**1.5**
Inflation	**3.5**	**0.8**	**1.6**	**2.9**	**3.3**	**1.3**	**0.8**	**1.2**

(*) Contribution to growth
Source: BBVA Research

Table 5.10
Portugal: GDP growth and inflation forecasts (%YoY)

	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	1.3	-2.3	2.5	-3.3	-5.3	-1.7	0.2	0.7
Public consumption	0.3	4.7	0.1	-5.0	-4.7	-2.3	-1.9	-0.5
Gross Fixed Capital Formation	-0.3	-8.6	-3.1	-10.5	-14.4	-7.8	1.4	3.0
Inventories (*)	0.0	-1.1	0.9	-0.2	0.1	0.0	0.0	0.0
Domestic Demand (*)	**0.9**	**-3.6**	**2.0**	**-5.6**	**-6.9**	**-2.8**	**0.0**	**0.8**
Exports	-0.1	-10.9	10.2	6.9	3.2	6.0	5.3	4.9
Imports	2.3	-10.0	8.0	-5.3	-6.6	2.5	3.3	4.1
Net exports (*)	**-1.0**	**0.6**	**-0.1**	**4.4**	**3.7**	**1.3**	**0.8**	**0.4**
GDP	**-0.1**	**-2.9**	**1.9**	**-1.1**	**-3.2**	**-1.5**	**0.8**	**1.2**
Inflation	**2.7**	**-0.9**	**1.4**	**3.6**	**2.8**	**0.4**	**0.6**	**1.2**

(*) Contribution to growth
Source: BBVA Research

Table 5.11
Spain: GDP growth and inflation forecasts (% YoY)

	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-0.6	-3.7	0.2	-1.2	-2.8	-2.4	0.9	1.3
Public consumption	5.9	3.7	1.5	-0.5	-4.8	-1.2	-1.1	1.3
Gross Fixed Capital Formation	-4.7	-18.0	-5.5	-5.4	-7.0	-5.9	0.2	5.2
Equipment and other products	-2.9	-23.9	4.3	5.3	-3.9	0.8	6.0	7.8
Construction	-5.8	-16.6	-9.9	-10.8	-9.7	-10.2	-3.8	3.1
Housing	-9.1	-20.4	-11.4	-12.5	-8.7	-8.4	-3.4	5.0
Other construction	-1.6	-12.2	-8.4	-9.2	-10.6	-11.8	-4.2	1.5
Inventories (*)	0.1	-0.2	0.3	-0.1	0.0	0.0	0.0	0.0
Domestic Demand (*)	**-0.5**	**-6.7**	**-0.6**	**-2.1**	**-4.1**	**-2.8**	**0.4**	**2.0**
Exports	-1.0	-10.0	11.7	7.6	2.1	5.2	6.5	6.7
Imports	-5.2	-17.2	9.3	-0.1	-5.7	0.3	5.2	7.4
Net exports (*)	**1.4**	**2.9**	**0.4**	**2.1**	**2.5**	**1.6**	**0.6**	**-0.1**
GDP	**0.9**	**-3.8**	**-0.2**	**0.1**	**-1.6**	**-1.2**	**0.9**	**1.9**
Inflation	**4.1**	**-0.3**	**1.8**	**3.2**	**2.4**	**1.4**	**0.5**	**1.0**

(*) Contribution to growth
Source: BBVA Research

Table 5.12
UK: GDP growth and inflation forecasts (% YoY)

	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-1.0	-3.6	1.0	-0.4	1.5	2.3	2.2	2.1
Public consumption	2.2	0.6	0.5	0.0	1.6	0.4	0.5	-0.2
Gross Fixed Capital Formation	-6.9	-16.7	2.8	-2.4	0.7	-2.0	6.7	5.8
Inventories (*)	-0.2	-1.5	1.2	0.4	-0.5	0.7	0.0	0.0
Domestic Demand (*)	**-1.6**	**-6.1**	**2.1**	**-0.1**	**0.9**	**2.0**	**2.4**	**2.2**
Exports	1.1	-8.7	6.7	4.5	1.1	0.5	2.7	4.2
Imports	-1.7	-10.7	7.9	0.3	3.1	0.9	1.8	3.4
Net exports (*)	**0.9**	**0.9**	**-0.5**	**1.2**	**-0.7**	**-0.1**	**0.3**	**0.2**
GDP	**-0.8**	**-5.2**	**1.7**	**1.1**	**0.3**	**1.9**	**2.6**	**2.4**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.6**	**1.9**	**2.0**

(*) Contribution to growth
Source: BBVA Research

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