

Europe Economic Outlook

May 2014

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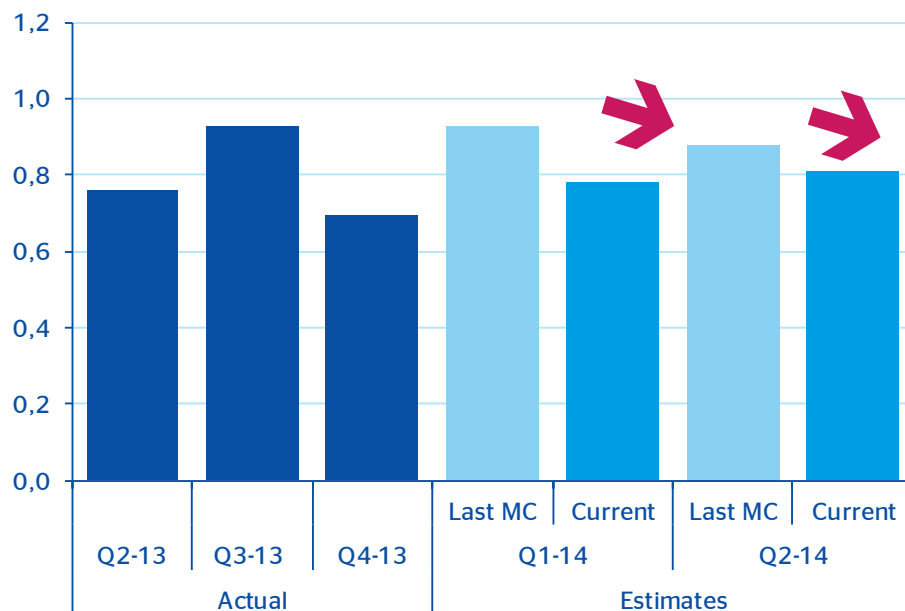
Country detail

Global cycle: growth remains robust at a quarterly 0.8% in the first half of the year

World GDP Growth (% QoQ)

Based on BBVA-GAIN

Source: BBVA Research



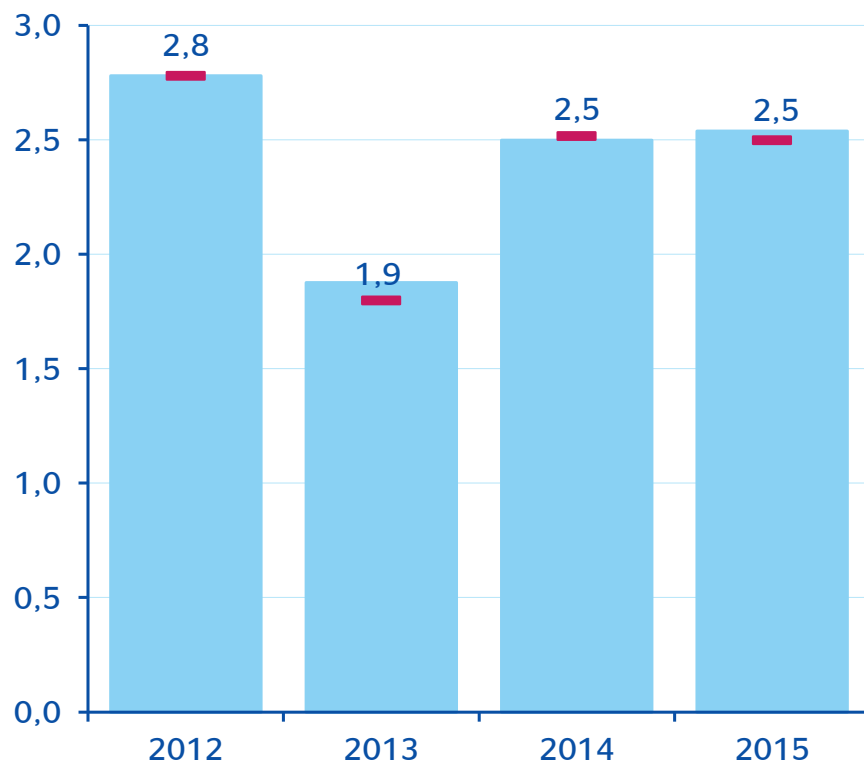
Overall, higher growth in developed economies partly offsets lower growth in emerging economies

Growth is still robust and financial conditions have also eased in emerging economies, but incoming information reveal no acceleration in the first half of 2014

US: incoming information fits our baseline scenario

US: GDP growth (% YoY)

Source: BBVA Research, BEA



■ Baseline Apr-2014 ■ Baseline Jan-2014

We maintain our baseline scenario for growth, the 1Q14 slowdown should be short-lived (bad weather related)

The balance of risks remain slightly biased to the upside

The FED will end tapering by the end of the year and will start increasing the Fed funds rate in 2nd half 2015

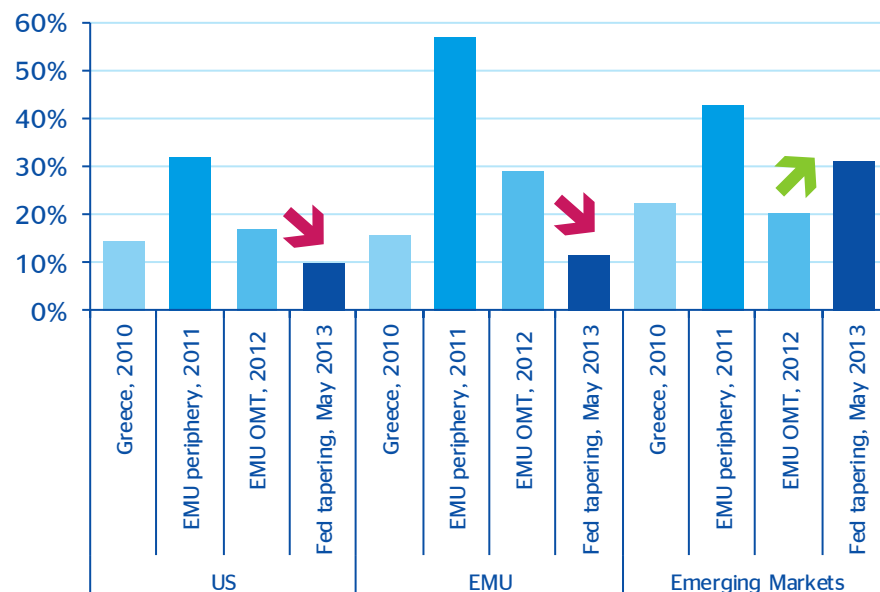
Monetary return to normal in the US is an event of global impact in financial markets

In May 2013 markets perceived that the end to Fed's balance raise was near, which increased global volatility, especially in emerging markets

Financial tensions vs. Lehman

BBVA Research's Financial Tension Index vs. Lehman=100%

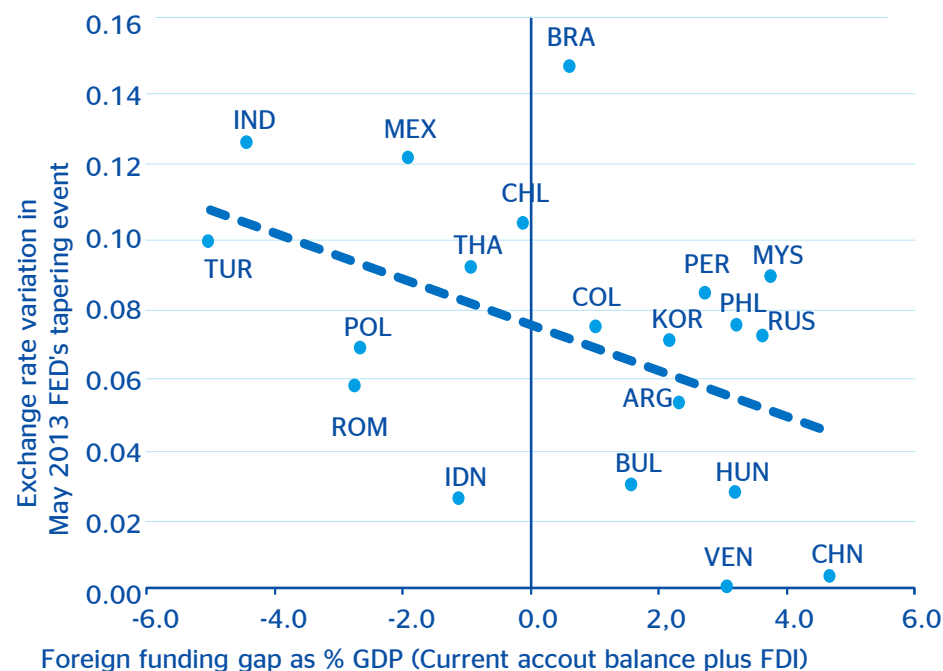
Source: BBVA Research



Exchange rate volatility was higher in emerging economies with larger external financial dependency

Exchange rate volatility in May-June 2013 and external financial needs

Source: BBVA Research

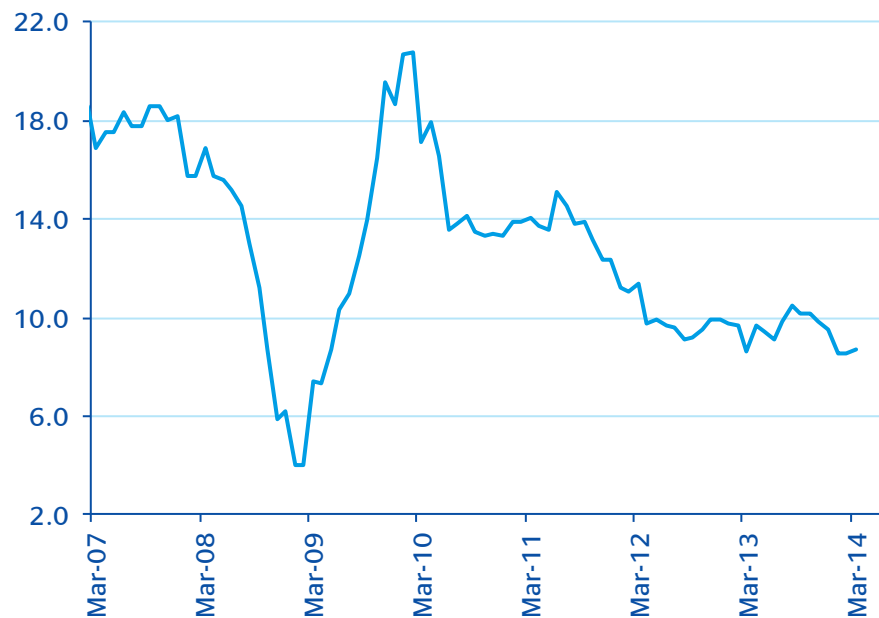


China: growth started weak in 2014

China's indicators are losing momentum ...

China: industrial production (YoY %)

Source: Haver and BBVA Research

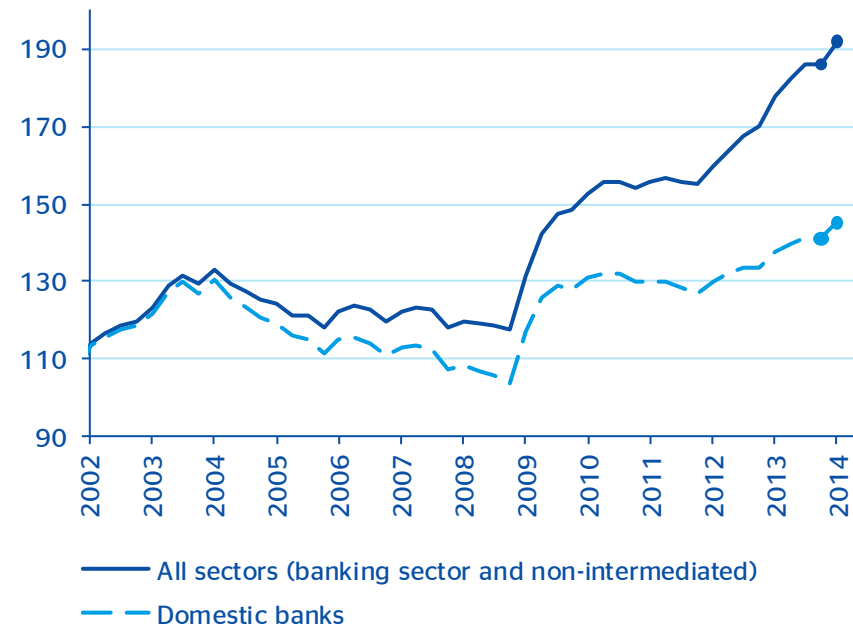


... as the authorities are more focused on reducing vulnerabilities with less room for manoeuvre in the short term

China: debt in the non-financial private sector

Total debt as % GDP

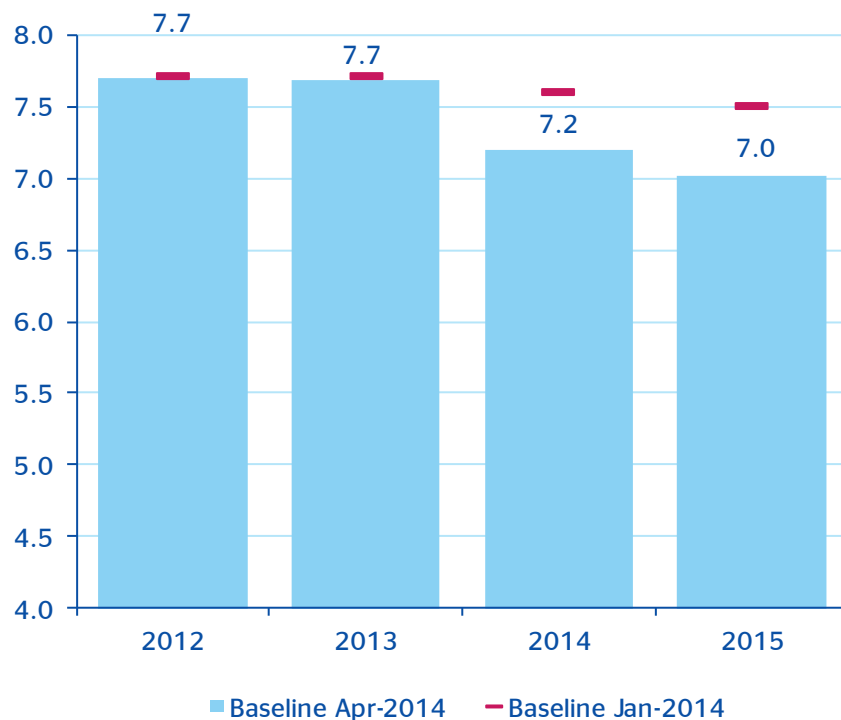
Source: BBVA Research, BIS and OECD



China: the baseline scenario has been updated due to poor incoming data and new assumptions on economic policy

China: GDP growth (% YoY)

Source: BBVA Research



The government will continue with reforms and will implement measures to reduce financial risks

We expect a higher adjustment in investment than in consumption

In case of higher than expected deceleration in the economy (below 7%), there is room for public response (investment in infrastructure, fiscal stimulus)

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Drivers of (slow) growth in the eurozone

1) Incoming data are better, especially confidence

2) The financial environment has improved, especially in the periphery

3) Fiscal policy is less restrictive

4) Monetary policy is loose and ECB is ready to provide further support

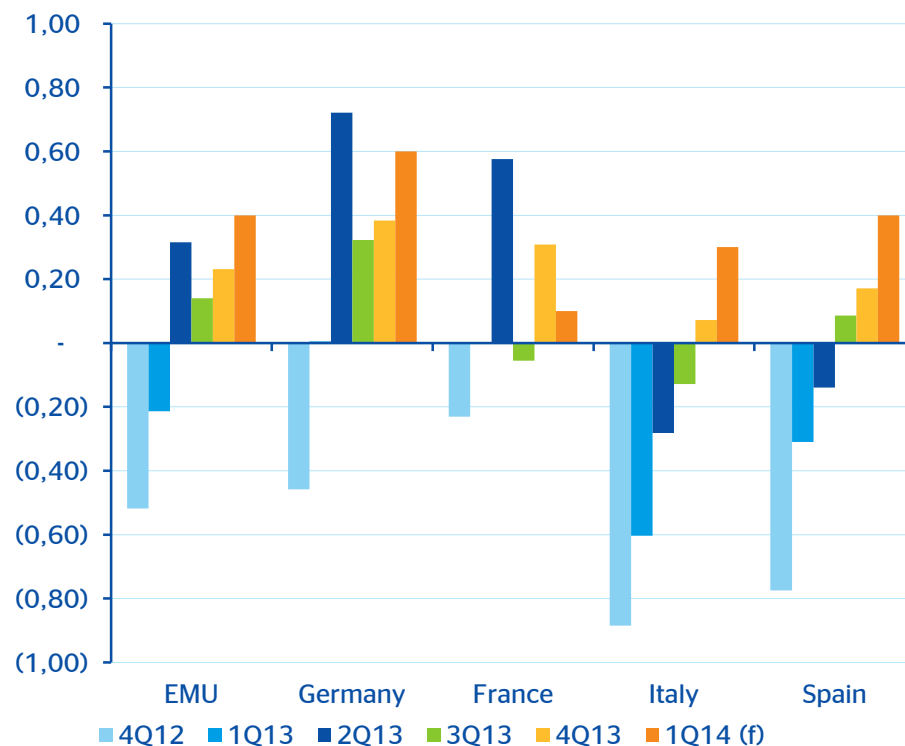
5) The banking union is advancing broadly as expected

6) The external environment is supportive, but with some doubts and a high euro exchange rate

Incoming data: GDP growth has returned

GDP growth (% QoQ)

Source: BBVA Research



GDP growth moderately positive since 2Q2013, after a second recession

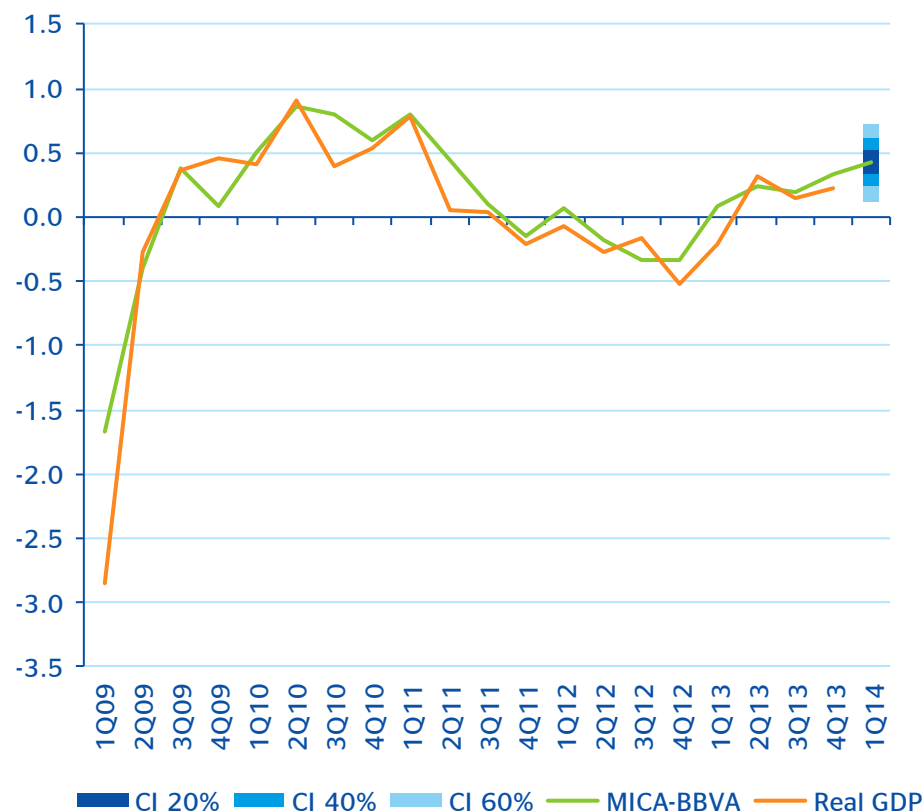
Germany clearly ahead of the rest

The periphery is now growing

Incoming data are positive: First quarter above expectations

MICA-BBVA model of short term GDP (% QoQ)

Source: Haver and BBVA Research

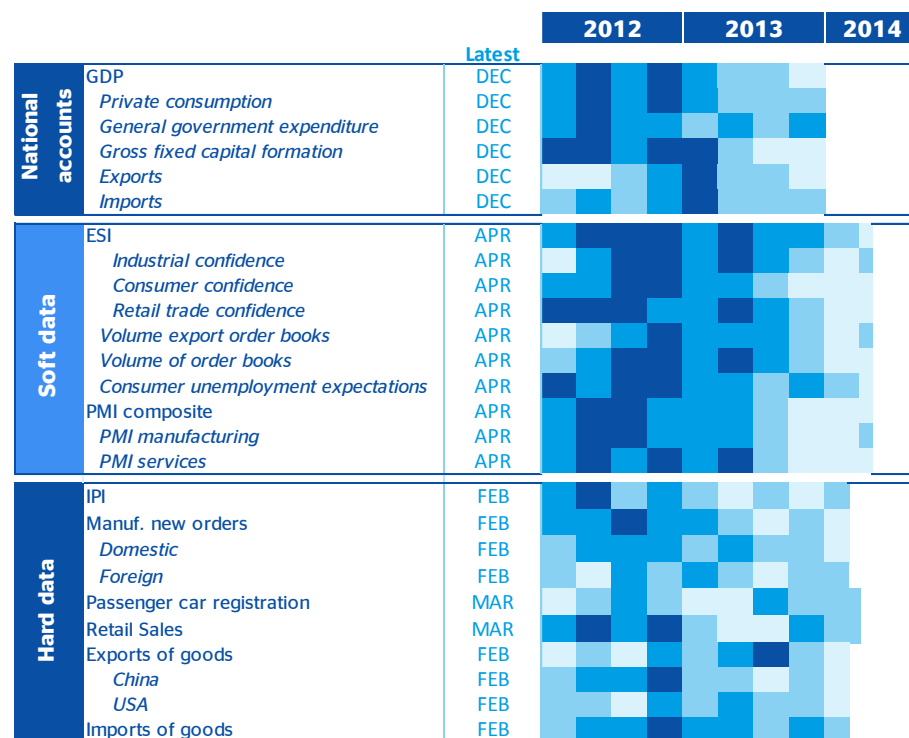


GDP growth projection for Q1 at 0.4% QoQ, above our previous projection (0.3%)

The second quarter has started also more positively than expected (0.2%)

Incoming data are positive: short-term indicators

Eurozone



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken.

For confidence data, standardized values are used, and the growth and fall are related to the mean.



Confidence data more positive since the start of the year

Activity indicators less upbeat than confidence

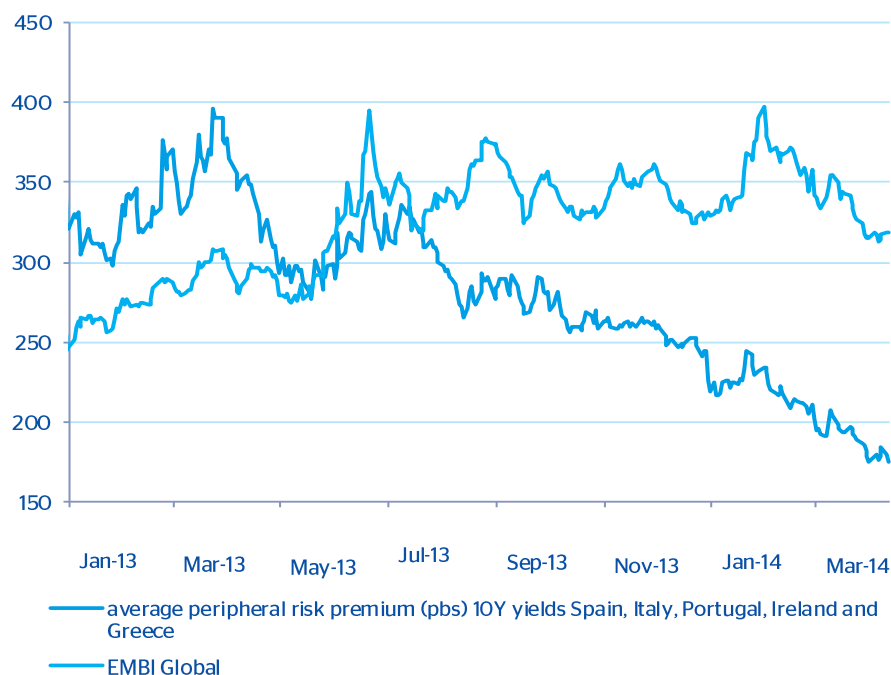
Exports have been more hesitant recently

The financial environment has improved

Further improvement in early 2014: Risk premia in the periphery continued to fall, and the bund's rates are lower due to the continued mention of QE by the ECB

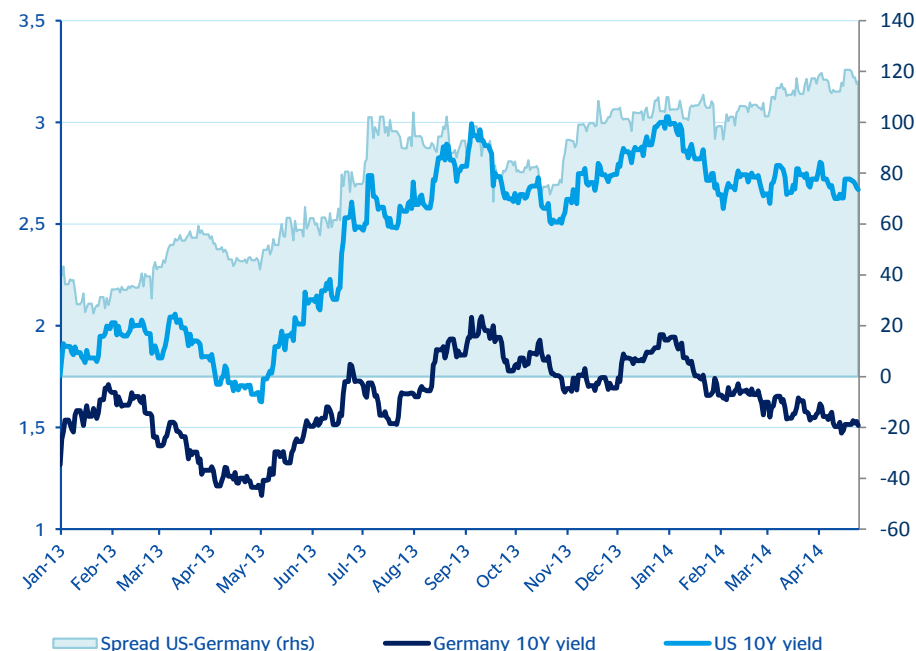
European peripheral risk and EM risk

Source: Bloomberg and BBVA Research



10Y bond yield: US and GER, %

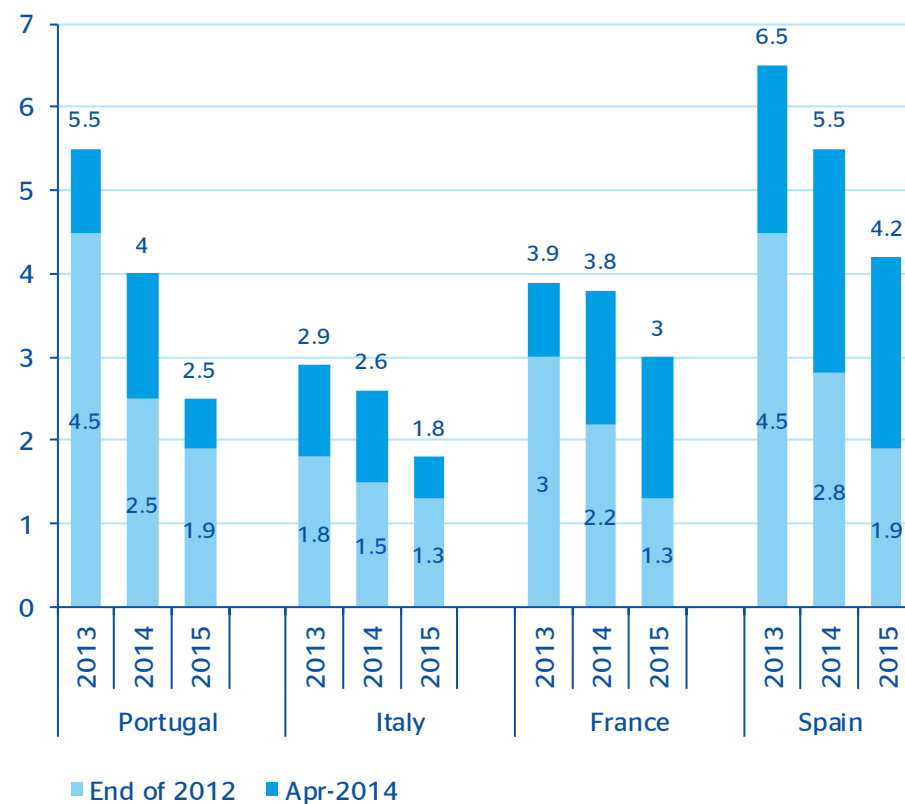
Source: Bloomberg and BBVA Research



Fiscal policy is less restrictive than in previous years

Change in public deficit targets

Source: Eurostat and BBVA Research



The Ecofin relaxed fiscal targets in May 2013 to avoid excessively procyclical policy

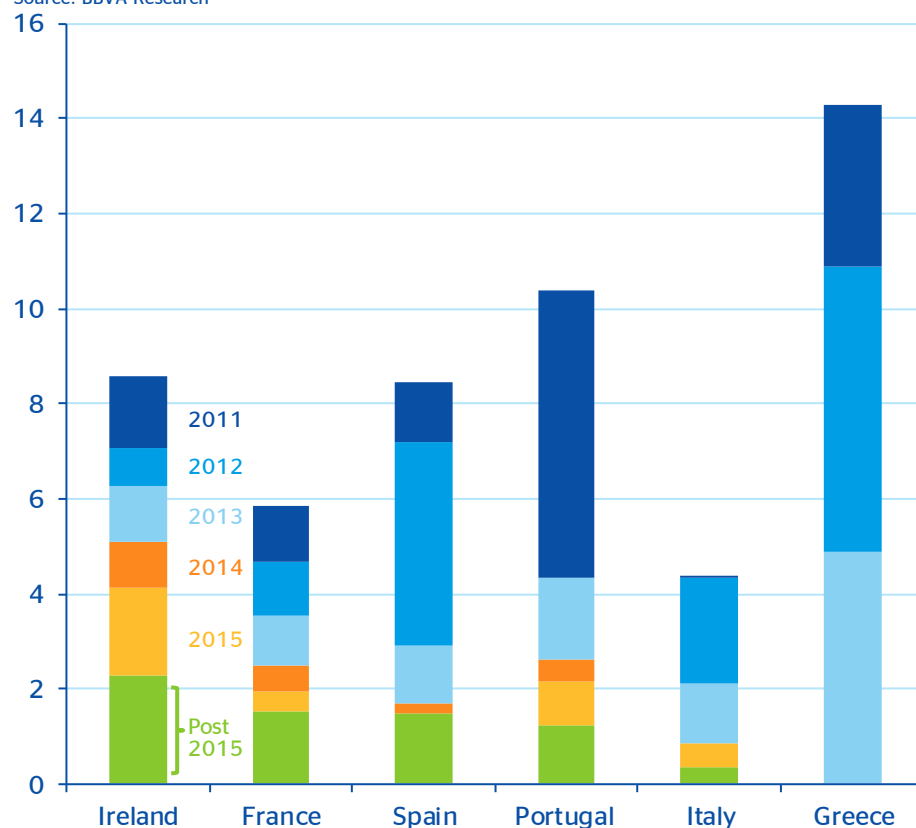
The 3% target was delayed for six countries, including, Portugal, Spain, France and Italy

The fiscal stance is now less restrictive

Fiscal policy is less restrictive than in previous years

Structural public deficit adjustment 2010-2015 (% GDP)

Source: BBVA Research



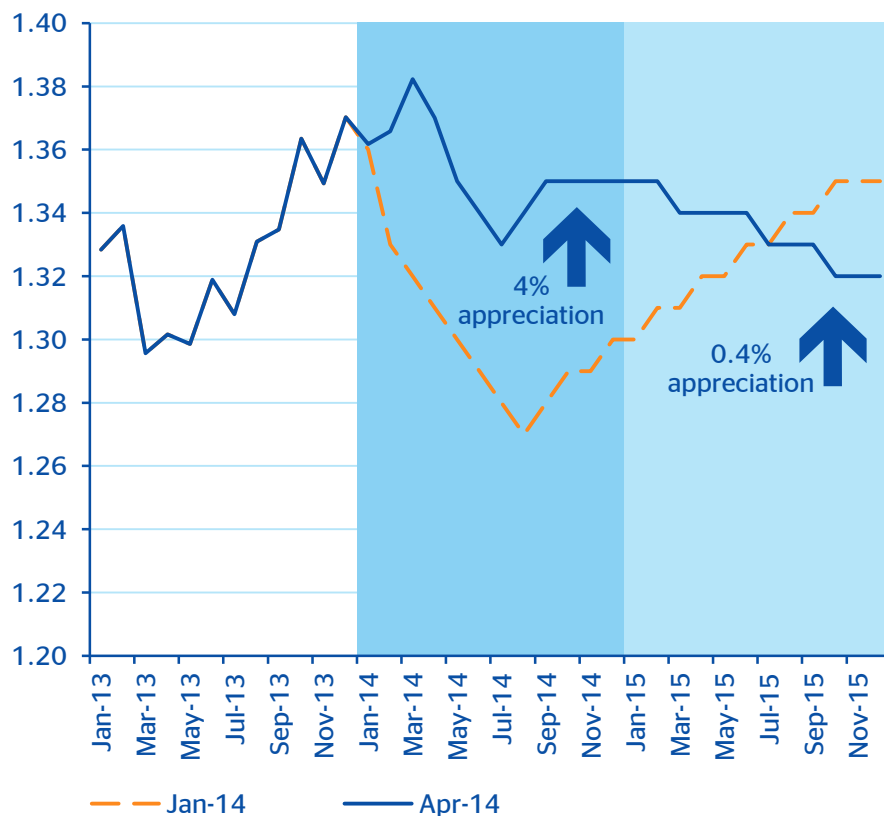
The adjustment of the structural deficit has been smaller in 2013 than in previous years

The remaining structural deficit after 2015 is still positive and will require further adjustment to comply with the fiscal compact

External environment positive, but with doubts on the impact from China and a high exchange rate

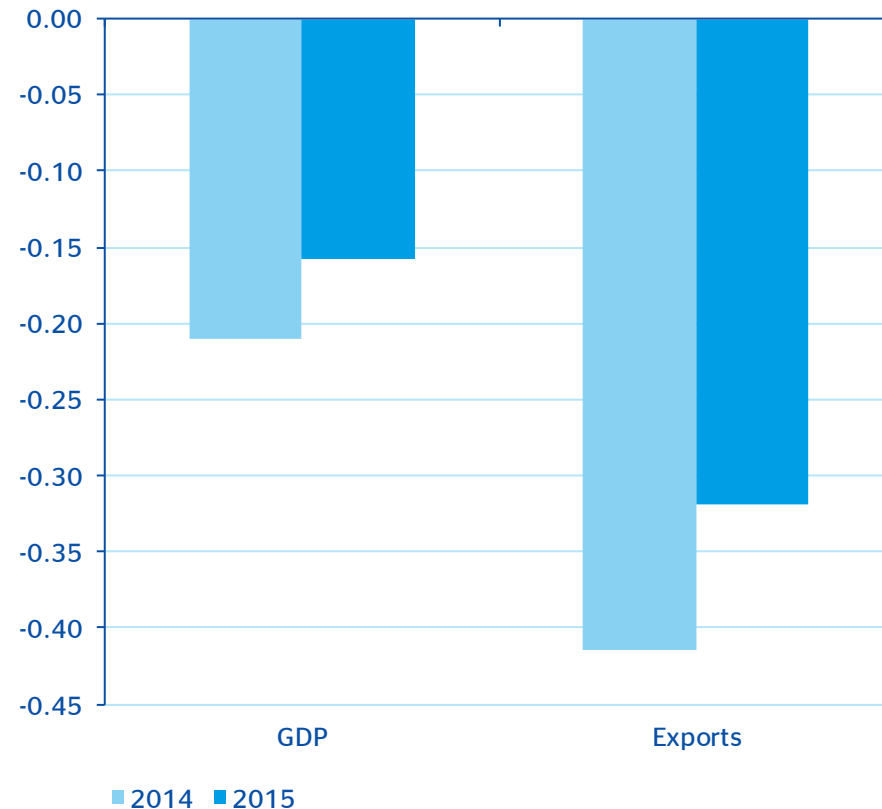
Dollar/euro exchange rate

Source: BBVA Research



Impact of strong euro on GDP and exports (pp)

Source: BBVA Research



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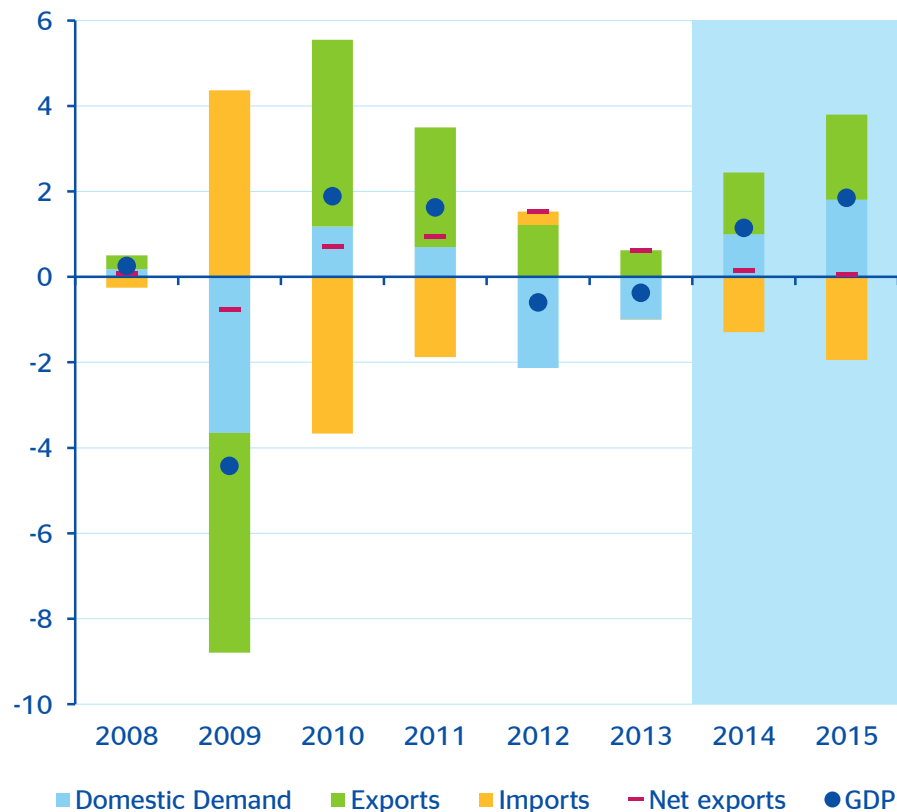
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Projections: Gradual recovery during 2014, with domestic demand playing an increasing role

EMU: annual contribution to GDP growth (pp)

Source: Eurostat and BBVA Research

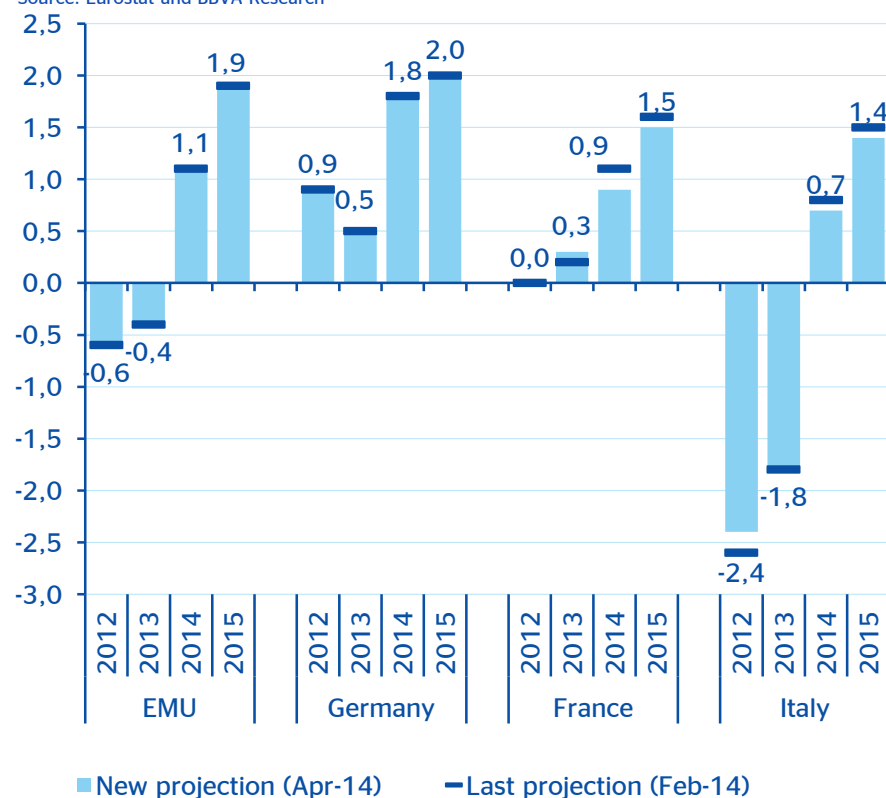


| | 2012 | 2013 | 2014 (f) | 2015 (f) |
|-------------------------------------|------|------|----------|----------|
| Economic activity | | | | |
| REAL GDP (yoy %) | -0.6 | -0.4 | 1.1 | 1.9 |
| Private Cons. | -1.4 | -0.7 | 0.8 | 1.3 |
| Public Cons. | -0.6 | 0.1 | 0.3 | 0.7 |
| Investment | -3.8 | -2.9 | 3.1 | 5.1 |
| Domestic Demand (contribution to %) | -2.1 | -1.0 | 1.0 | 1.8 |
| Exports | 2.7 | 1.4 | 3.1 | 4.2 |
| Imports | -0.8 | 0.0 | 3.1 | 4.6 |
| External Demand (contribution to %) | 1.5 | 0.6 | 0.1 | 0.0 |
| External sector | | | | |
| Current Account Balance (% GDP) | 1.2 | 2.3 | 2.2 | 2.1 |
| Public finance | | | | |
| General Government balance (% GDP) | -3.7 | -3.0 | -2.6 | -2.1 |
| Prices | | | | |
| CPI , % avg | 2.5 | 1.4 | 0.9 | 1.3 |
| REAL GDP (yoy %) | -0.6 | -0.4 | 1.1 | 1.9 |

By country: Germany will continue to outgrow the rest

Country GDP projections (%)

Source: Eurostat and BBVA Research



By country, Germany is more advanced in the recovery

France and Italy revised downwards and will converge over 2015

Uncertainties and sources of risk

1) Fed tapering may have an impact on long rates

2) Financial market fragmentation persists and credit remains subdued

3) Risks from lower growth in emerging countries, including China

4) Smooth AQR and stress tests results are needed for the recovery of credit

5) Several risks persist in the periphery. Adjustment needs to continue at the right pace

6) Risk of deflation or prolonged low inflation

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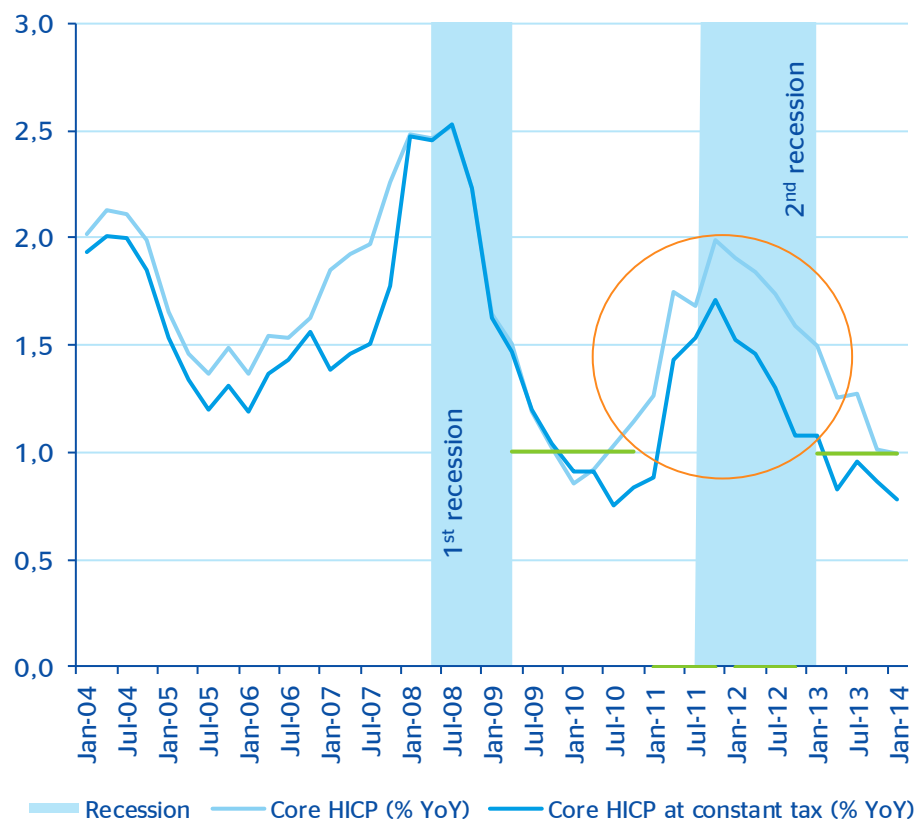
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Strong recession, especially in domestic demand, has weighed on prices since 2009

Eurozone: Core inflation (% YoY)

Source: Eurostat and BBVA Research



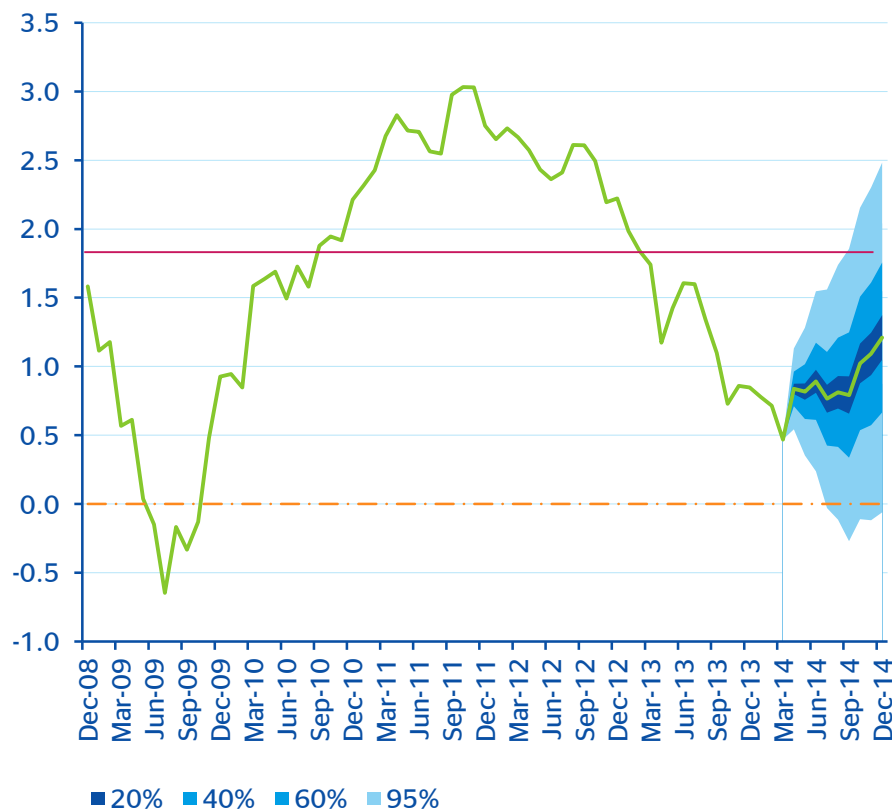
Inflation has declined coinciding with the past recession

The reversing of recent tax hikes has also had an impact on disinflation

Inflation is projected to remain at very low rates in the forecast horizon. Limited deflation risks

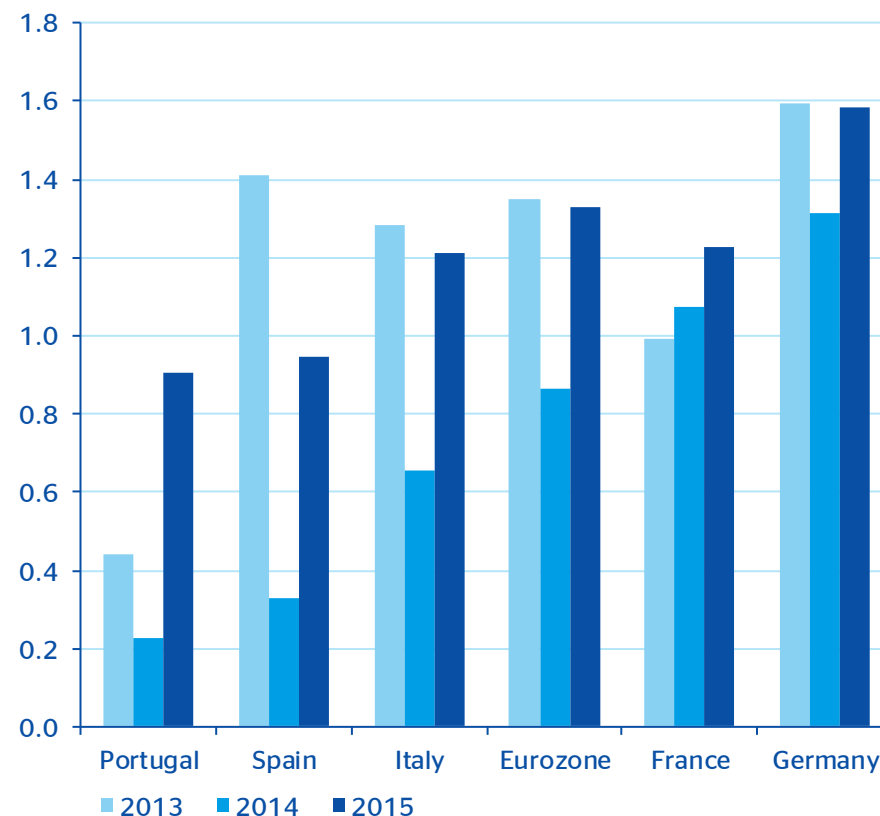
Eurozone: Inflation (% YoY)

Source: Eurostat and BBVA Research



Inflation by countries (% YoY)

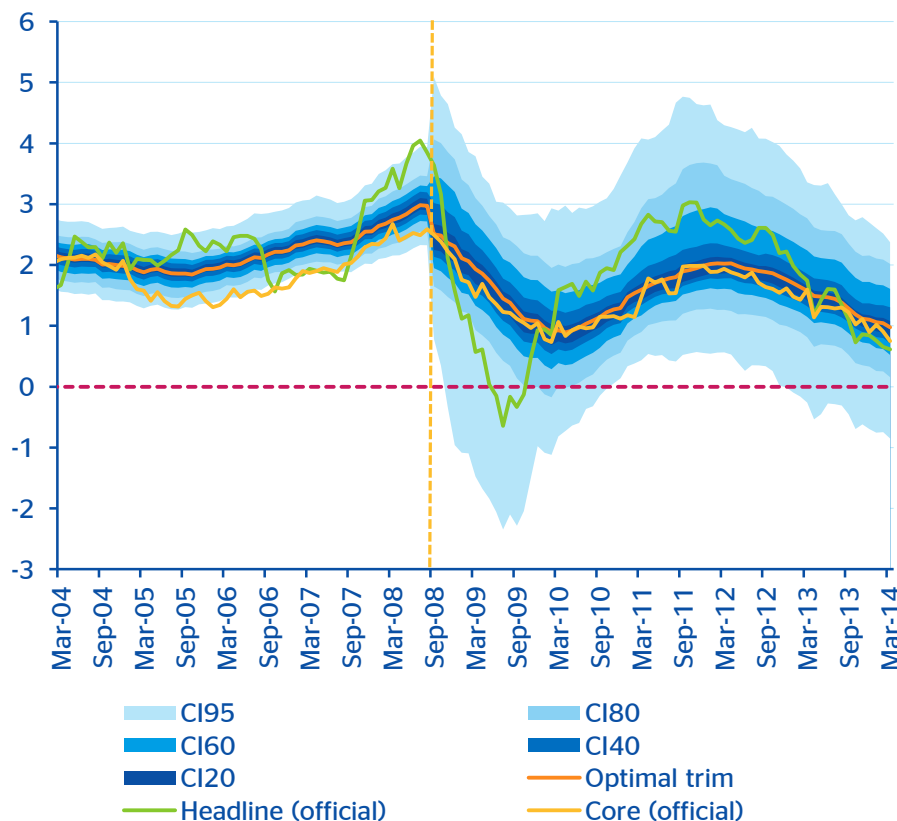
Source: Eurostat and BBVA Research



But very low inflation over a protracted period of time could end up pushing down inflation expectations

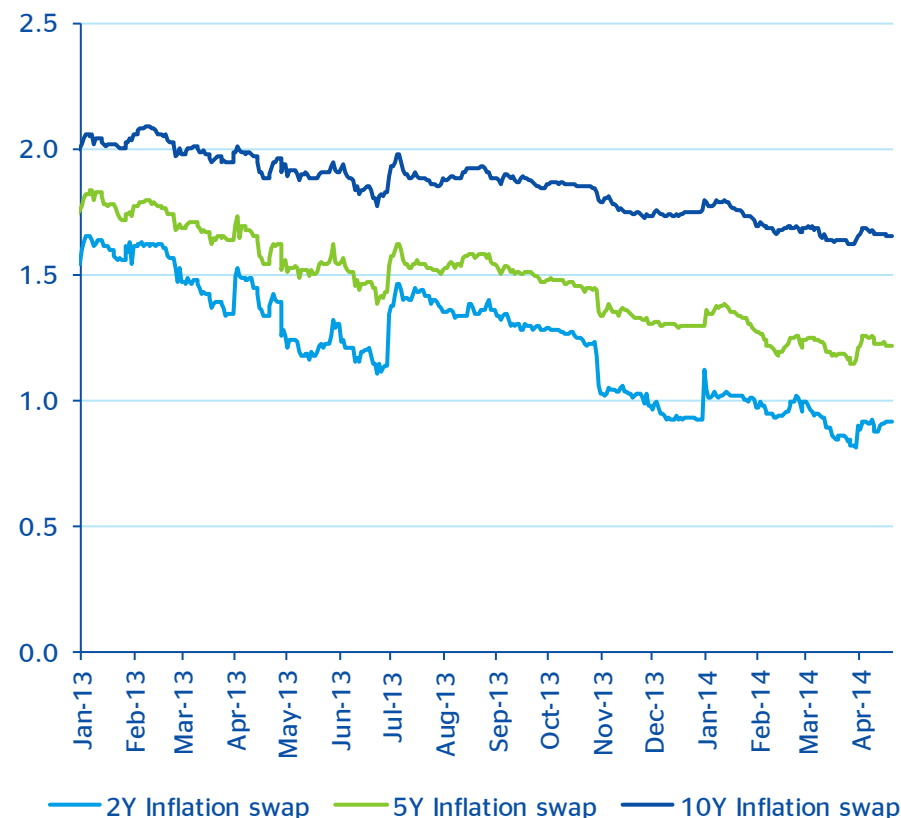
Eurozone: inflation (% YoY)

Source: BBVA Research



Eurozone: inflation swaps expectations (%)

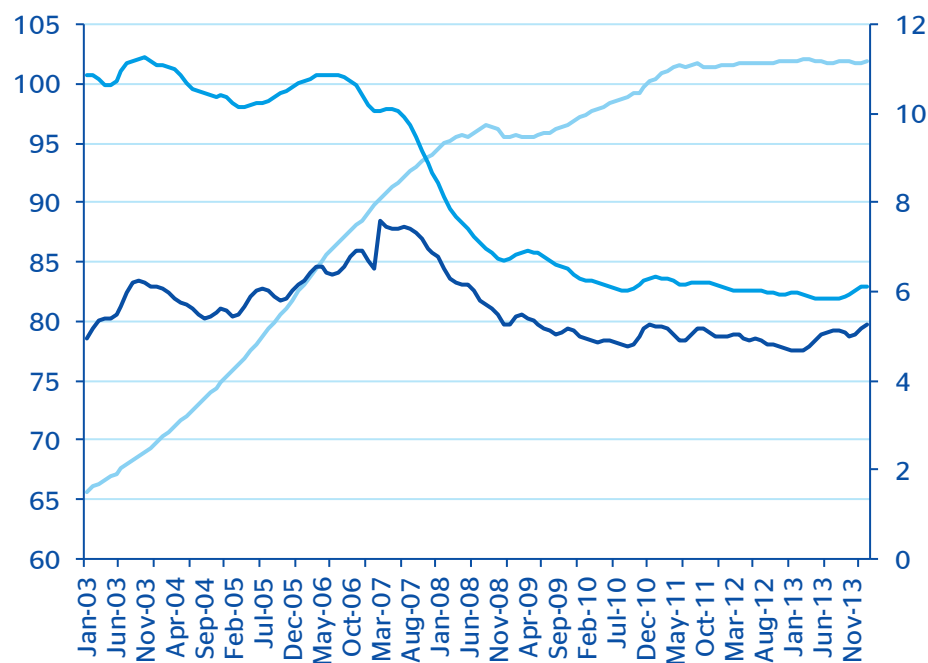
Source: Bloomberg and BBVA Research



New loans to households are recovering, mirroring consumption growth...

Eurozone: Stock of loans to households

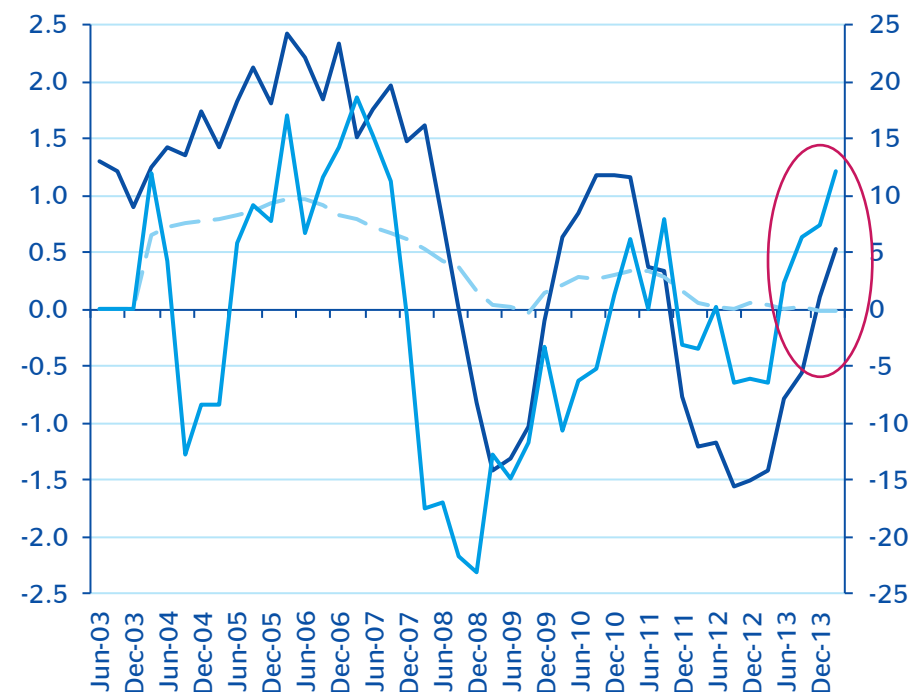
Source: Eurostat and BBVA Research



- Loans to households (Stock, s.a., Dec10=100, LHS)
- New consumers loans 1 to 5 yrs initial rate fix (Trend, Bil.EUR, RHS)
- New consumer loans over 5 yrs initial rate fix (Trend, Bil.EUR, RHS)

Eurozone: Growth of loans to households and private consumption (% YoY)

Source: Eurostat and BBVA Research

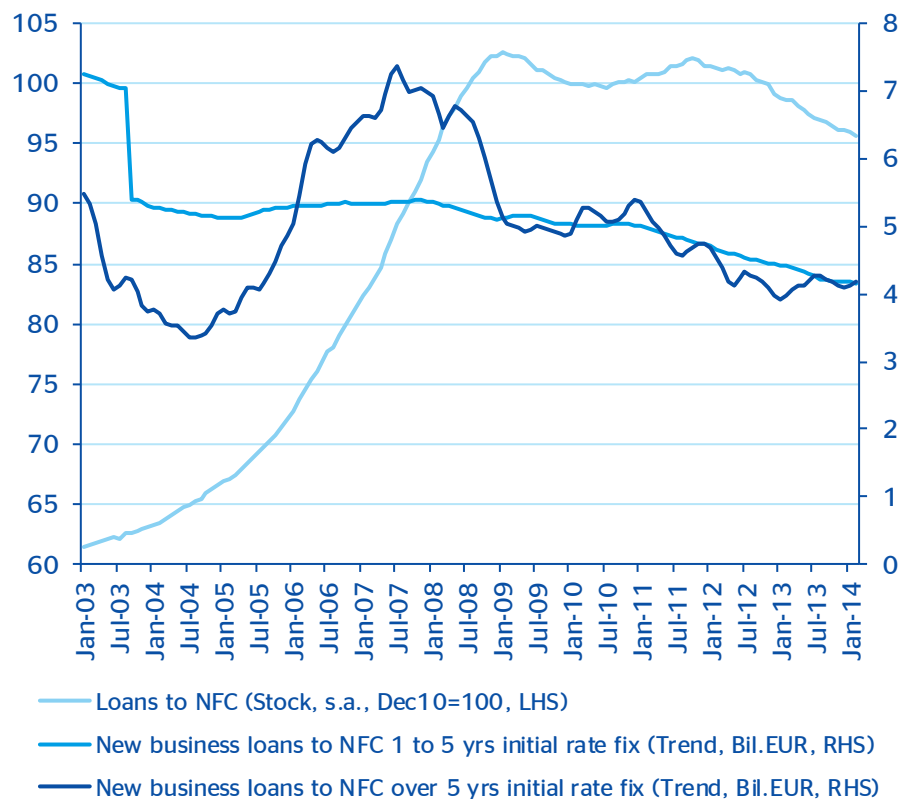


- Private consumption
- LHH Stock (RHS)
- New consumer loans over 5 yrs initial fix rate (RHS)
- New consumer loans 1 to 5 yrs initial rate fix (RHS)

... but the recovery of loans to firms is still very incipient

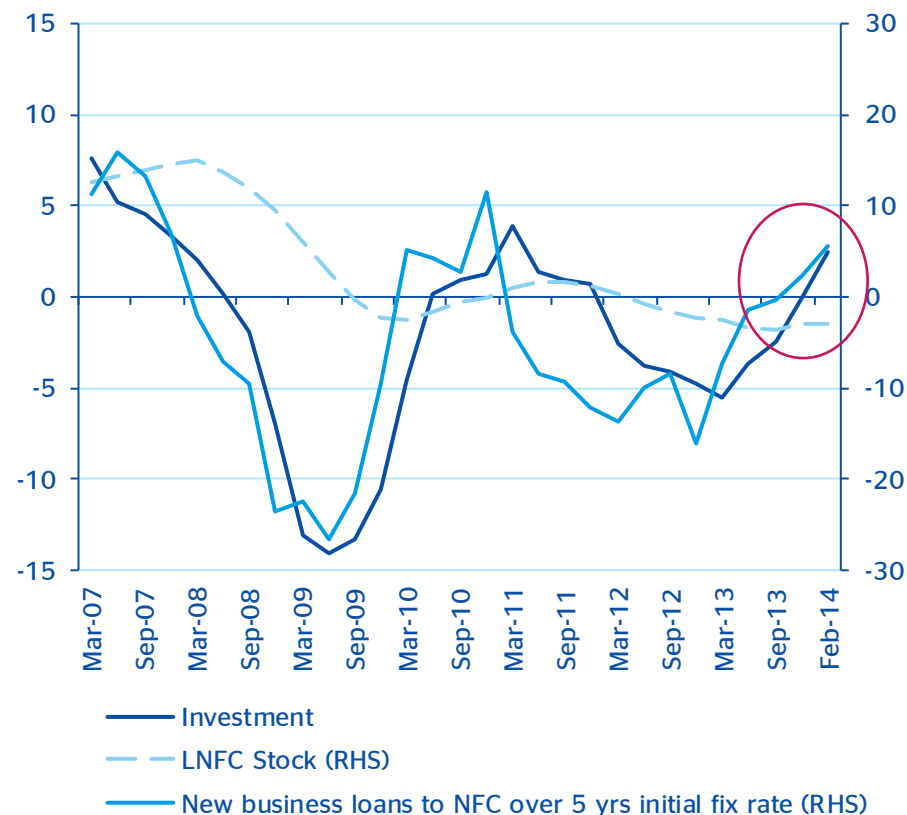
Eurozone: Loans to non-financial corporations

Source: Eurostat and BBVA Research



Eurozone: Loans to non-financial corporations and investment (% YoY)

Source: Eurostat and BBVA Research



ECB signals a more dovish stance, though communication is not always consistent

| | |
|---------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Nov-13 | Rate cut to 0.25% (refi) by surprise, given low inflation and doubts on the recovery |
| Jan/Feb | Talk of additional measures if needed |
| March | ECB remains on hold despite inflation forecasts at 1.5% for 2016, which implies non-compliance with its inflation target |
| April | QE is on the table: “Unanimous” commitment to use unconventional instruments to cope with “risks of a too prolonged period of low inflation” (not necessarily of deflation) |
| May | Draghi strongly signals more measures in June, after the new staff inflation projections are presented. The euro a “serious concern” |
| June | We expect a further cut in refi interest rates, and a negative deposit rate. Additional measures on liquidity are not discarded for the coming months |

QE is on the table, although it is not the central scenario

Draghi has clarified what measures could be used

Unwarranted tightening of policy stance
(money markets, bonds or euro)



Lower interest rate corridor,
negative deposit rate,
further extension of full allotment,
new liquidity injections

Further impairments in monetary policy
transmission



Targeted long-term refinancing
operation, ABS purchase

Worsening of the medium-term outlook
of inflation



A more broad-based asset purchase
programme (QE)

After the SRM, the comprehensive assessment will be the key event of the second half of 2014

Composed of 3 pillars

Supervisory Risk Assessment to review key risks, including liquidity, leverage and funding

Asset Quality Review (AQR) to analyze the quality of banks' assets, collateral valuation and provisions

Stress Test to examine the resilience of banks' balance sheet to stress scenarios

The exercise should be strict enough so as to dispel any doubts on the resilience of the balance-sheets.

Particular attention should be paid to the AQR, as most doubts surge on the current situation of the balance-sheets

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Macroeconomic imbalances heatmap

| | Public Debt | Public Deficit* | Unemployment Rate | Current Account | Net International Investment Position | Real Effective Exchange Rate | Nominal Unit Labour Cost | Household Debt | Non-Financial Corporations Debt | Loans to Households | Loans to Non-Financial Corporations |
|----------|------------------|-----------------|-------------------|-----------------|---------------------------------------|------------------------------|--------------------------|-----------------|---------------------------------|-----------------------|-------------------------------------|
| | % of GDP Q4-2013 | % of GDP 2013 | Latest | % of GDP 2013 | % of GDP Q4-2013** | 3-yr % chg. Sep. 2013 | 3-yr % chg. Latest | % of GDP Latest | % of GDP Latest | YoY % chg. March 2014 | YoY % chg. March 2014 |
| Eurozone | 92.7 | -2.8 | 11.8 | 2.4 | -12.2 | 1.0 | 3.9 | 63.9 | 81.5 | -0.1 | -3.0 |
| GER | 78.4 | 0.0 | 5.1 | 7.5 | 48.3 | 0.1 | 6.1 | 58.2 | 48.5 | 1.3 | -0.2 |
| FRA | 93.5 | -4.3 | 10.4 | -1.4 | -21.2 | -0.7 | 5.2 | 56.7 | 84.0 | 2.4 | 0.2 |
| AUT | 74.5 | -0.9 | 4.9 | 2.7 | 3.4 | 2.2 | 7.3 | 54.5 | 92.9 | 1.2 | -0.7 |
| BEL | 101.5 | -2.8 | 8.5 | -1.6 | 44.0 | 0.5 | 8.6 | 56.5 | 92.4 | 8.8 | 0.1 |
| NED | 73.5 | -2.5 | 7.2 | 10.4 | 53.0 | 1.5 | 6.4 | 127.9 | 91.5 | -2.8 | -1.0 |
| FIN | 57.0 | -2.1 | 8.5 | -1.1 | 15.8 | 1.9 | 8.5 | 65.4 | 92.5 | 2.2 | 6.2 |
| ITA | 132.6 | -3.1 | 12.7 | 1.0 | -30.0 | 2.0 | 4.3 | 45.3 | 81.0 | -1.2 | -4.7 |
| SPA | 93.9 | -6.6 | 25.3 | 0.8 | -98.2 | 0.8 | -5.3 | 81.3 | 114.0 | -4.4 | -10.0 |
| POR | 129.0 | -4.5 | 15.2 | 0.5 | -118.7 | 0.2 | -1.3 | 86.8 | 130.8 | -3.9 | -5.5 |
| IRE | 123.7 | -6.7 | 11.8 | 6.6 | -104.9 | -2.4 | -3.4 | 105.1 | 201.3 | -2.9 | -6.6 |
| GRC | 175.1 | -2.1 | 26.5 | 0.7 | -119.0 | -3.9 | -11.1 | 64.5 | 64.8 | -3.1 | -5.8 |
| CYP | 111.7 | -5.2 | 17.4 | -1.9 | -85.7 | 0.1 | -6.3 | 137.1 | 162.1 | -7.3 | -4.7 |
| SLV | 71.7 | -4.3 | 9.7 | 6.3 | -37.9 | 0.8 | -0.8 | 29.6 | 74.0 | -2.7 | -15.8 |
| SLK | 55.4 | -2.8 | 13.9 | 2.1 | -65.1 | 3.0 | 0.8 | 28.3 | 44.8 | 10.7 | 0.8 |
| DEN | 44.5 | -0.9 | 6.5 | 7.3 | 39.6 | -1.4 | 3.8 | 139.2 | 97.9 | -2.2 | 1.7 |
| SWE | 40.6 | -1.1 | 8.1 | 6.2 | -4.8 | 3.1 | 6.2 | 83.4 | 121.2 | -2.1 | -6.7 |
| U.K. | 90.6 | -5.7 | 6.7 | -4.4 | -1.3 | 3.9 | 6.2 | 93.1 | 83.8 | 3.9 | -5.0 |

Colour criterion:

| | | | | | | | | | | |
|-----------------|----------------|----------------|----------------|-----------------|----------------|----------------|------------------|------------------|-----------------|-----------------|
| Higher than 130 | Lower than -6 | Higher than 16 | Lower than -6 | Lower than -100 | Greater than 6 | Greater than 9 | Greater than 110 | Greater than 140 | Greater than 10 | Greater than 10 |
| 110/130 | -6/-5 | 13/16 | -6/-4 | -100/-50 | 4/6 | 6/9 | 90/110 | 120/140 | 7/10 | 7/10 |
| 90/110 | -5/-4 | 10/13 | -4/-2 | -50/0 | 2/4 | 3/6 | 75/90 | 100/120 | 4/7 | 4/7 |
| 60/90 | -4/-3 | 7/10 | -2/0 | 0/20 | 0/2 | 0/3 | 60/75 | 80/100 | 0/4 | 0/4 |
| Lower than 60 | Higher than -3 | Lower than 7 | Greater than 0 | Greater than 20 | Lower than 0 | Lower than 0 | Lower than 60 | Lower than 80 | Lower than 0 | Lower than 0 |

*Excluding Financial Sector Assistance

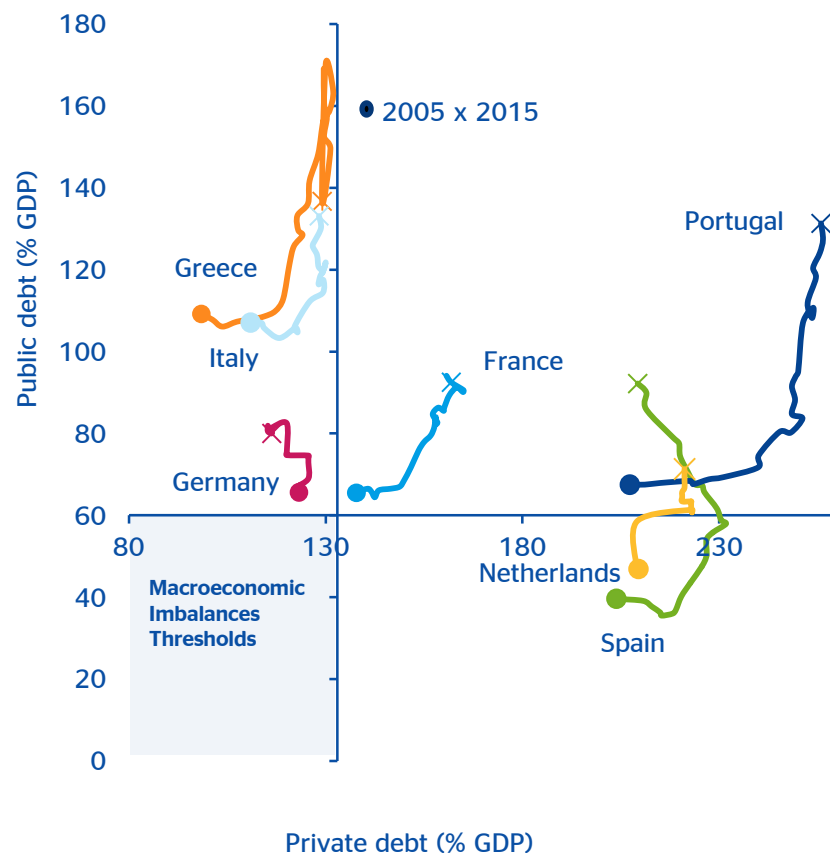
**Data for France refer to Q4-2012

Source: Eurostat, ECB, Haver and BBVA Research

Deleveraging still not present, with exceptions

Public and private debt 2005-2015 (% GDP)

Source: Eurostat and BBVA Research



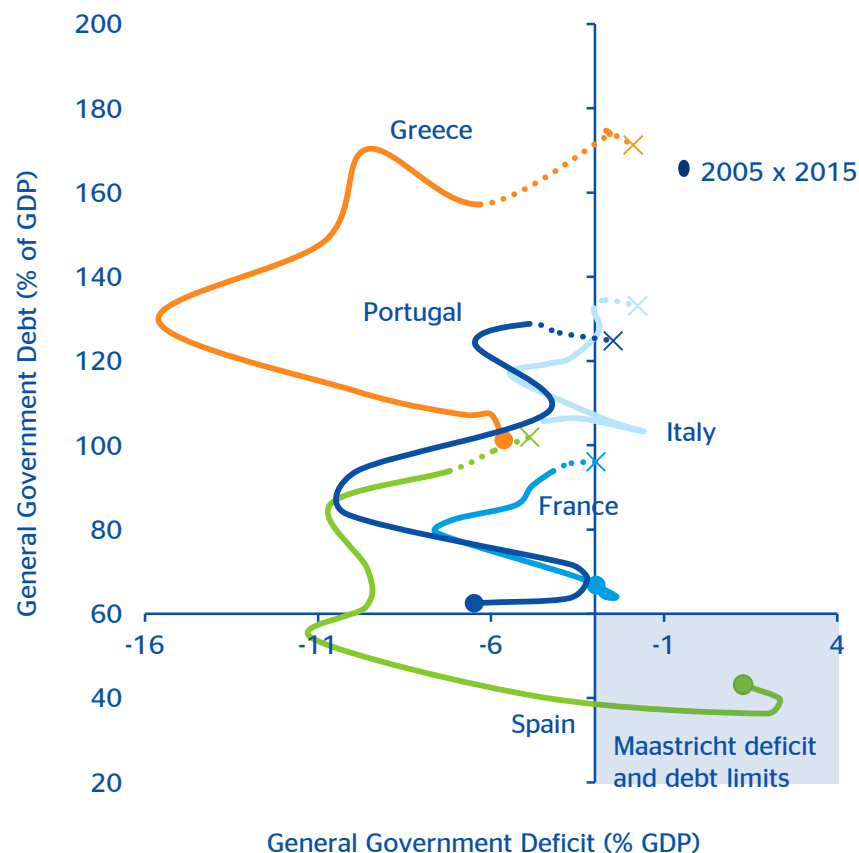
Private debt has stabilized and started to fall in Spain

Periphery countries have experienced much larger debt increases during the crisis than the core

Periphery countries have reduced public deficits but public debts are still growing

Government debt and deficit 2005-2015

Source: IMF



The adjustment of the deficit has been large, especially in countries under programme

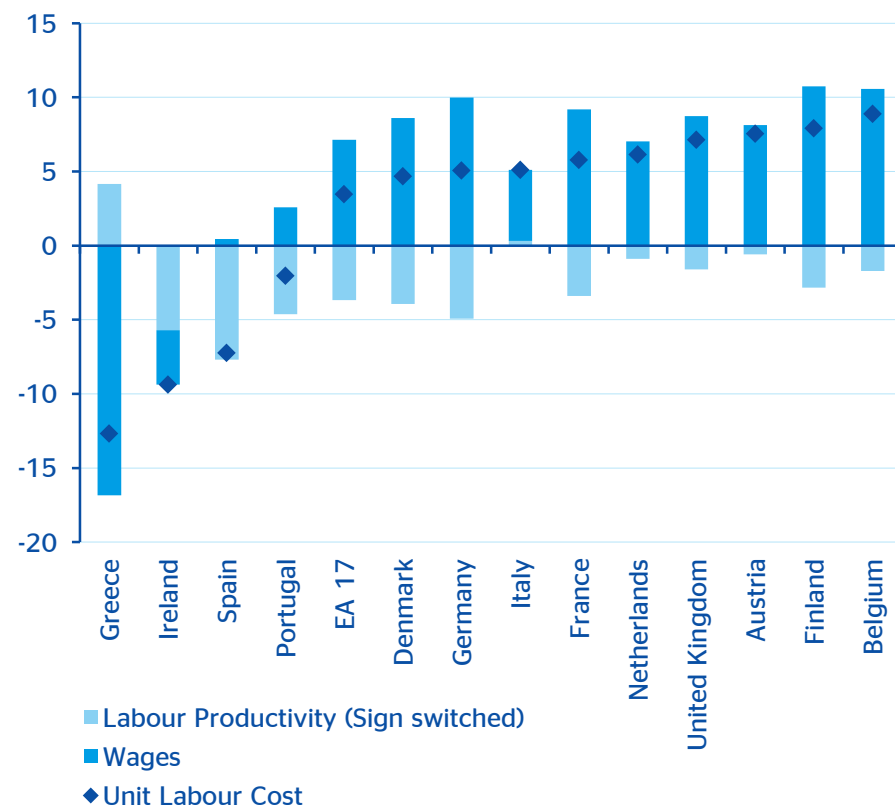
But debt levels have not started to fall yet

The return to growth and higher inflation are key to rapid deleveraging

Unit labour costs have adjusted rapidly in the periphery

Unit Labour Cost Adjustment, 2009-2013 (%)

Source: Haver and BBVA Research



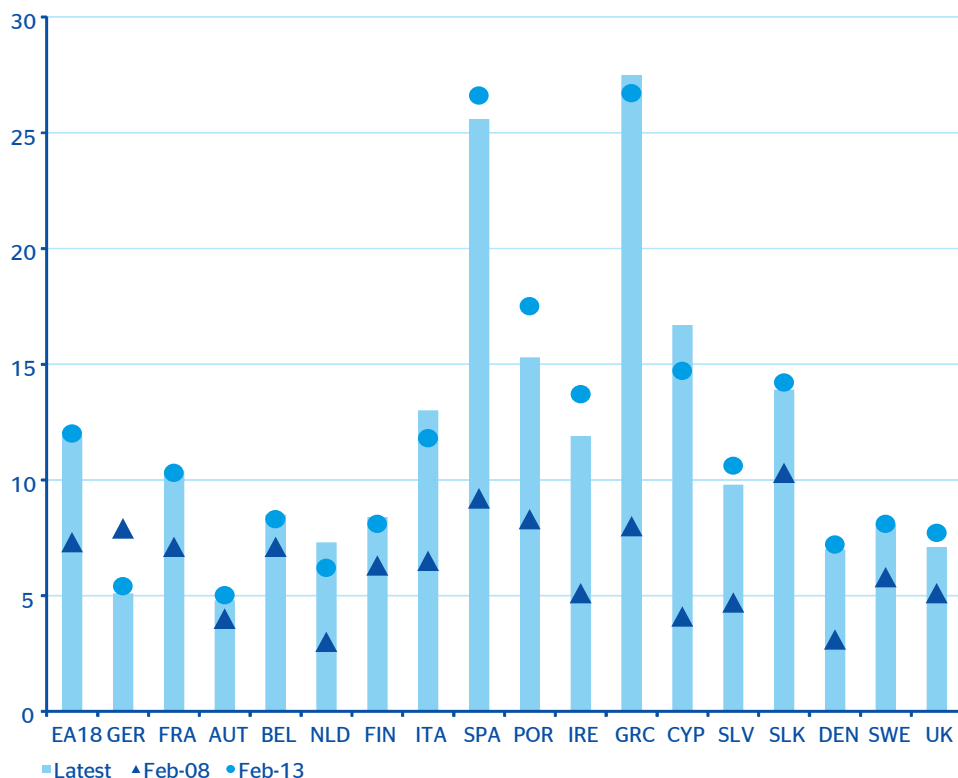
In some countries such an adjustment is due to higher productivity, due to the fall of employment

Wage moderation has also played a role, especially in comparison to core countries

Periphery countries have reduced deficits but public debts are still growing

Unemployment since the beginning of the crisis (%)

Source: Haver and BBVA Research



In some countries such an adjustment is due to higher productivity, due to the fall of employment

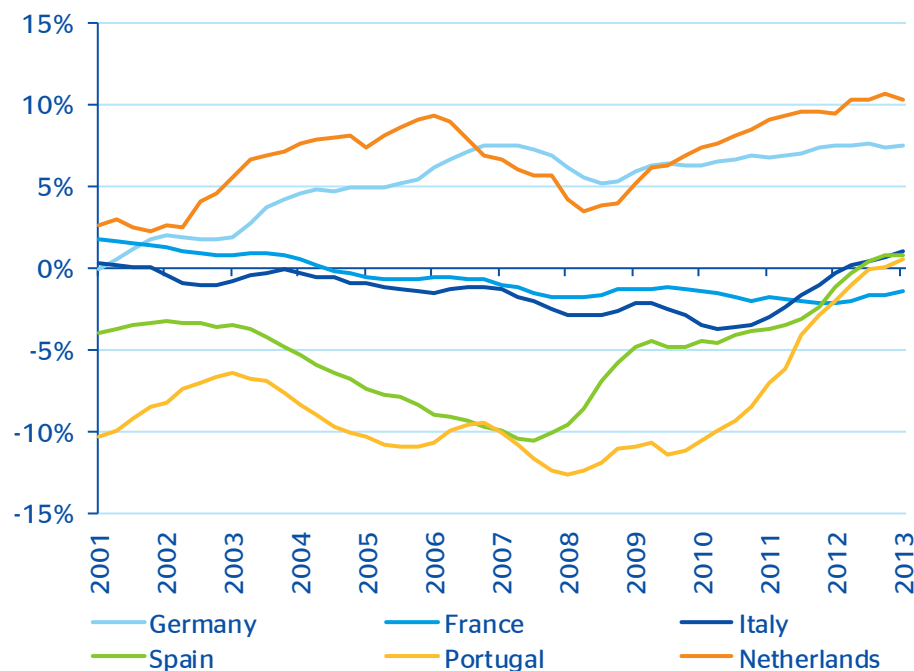
Wage moderation has also played a role, especially in comparison to core countries

Current accounts have adjusted much faster than expected

Most EZ countries now in surplus (barring France)

Current account (% of GDP)

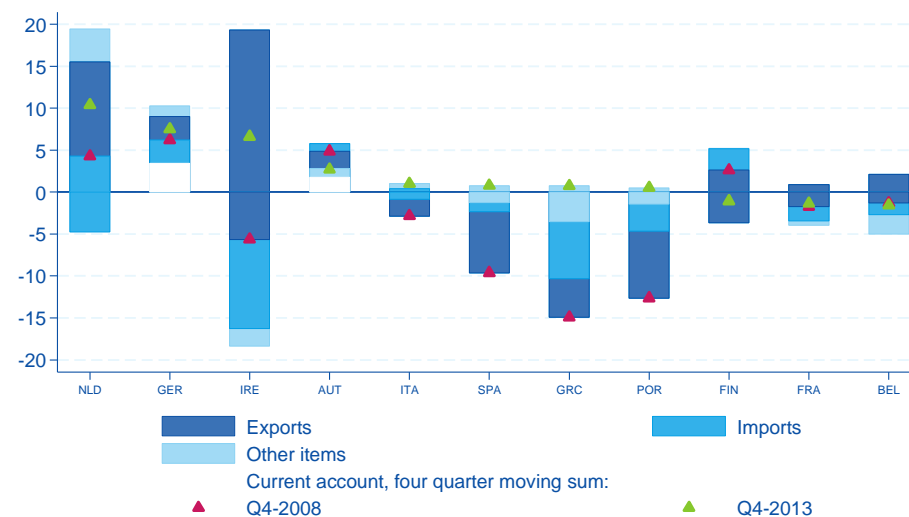
Source: Eurostat and BBVA Research



Part of the adjustment due to recession (lower imports), but exports also played a big role

Current account (% of GDP)

Source: Eurostat and BBVA Research



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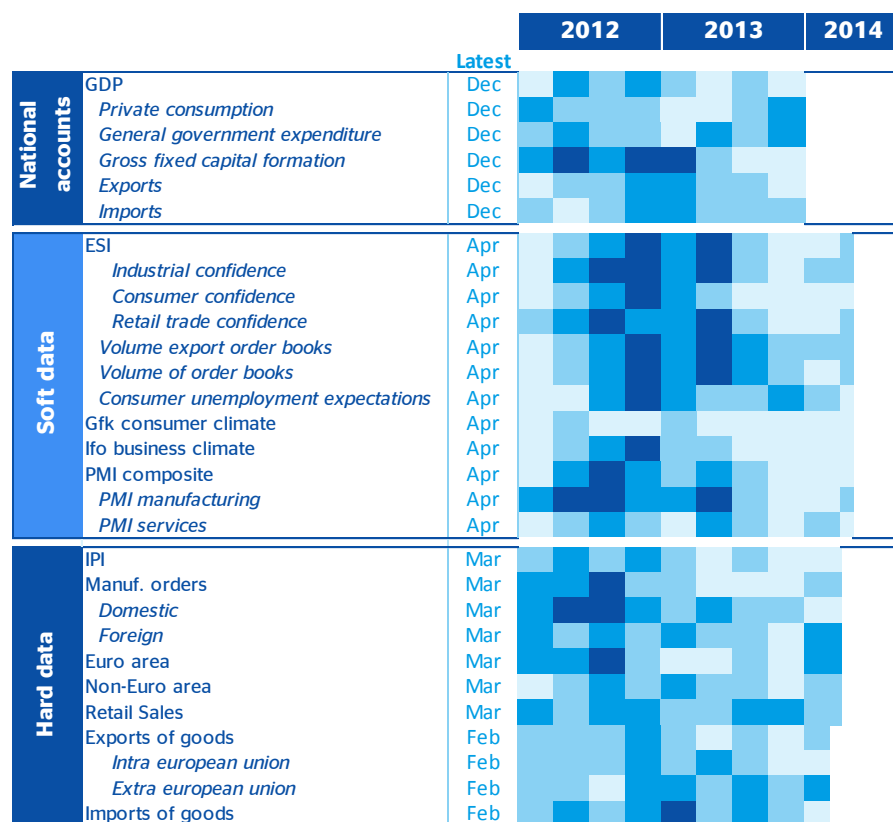
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Germany: Growing weight of domestic fundamentals



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken.

For confidence data, standardized values are used, and the growth and fall are related to the mean.



Confidence indicators reached their peak in Q1

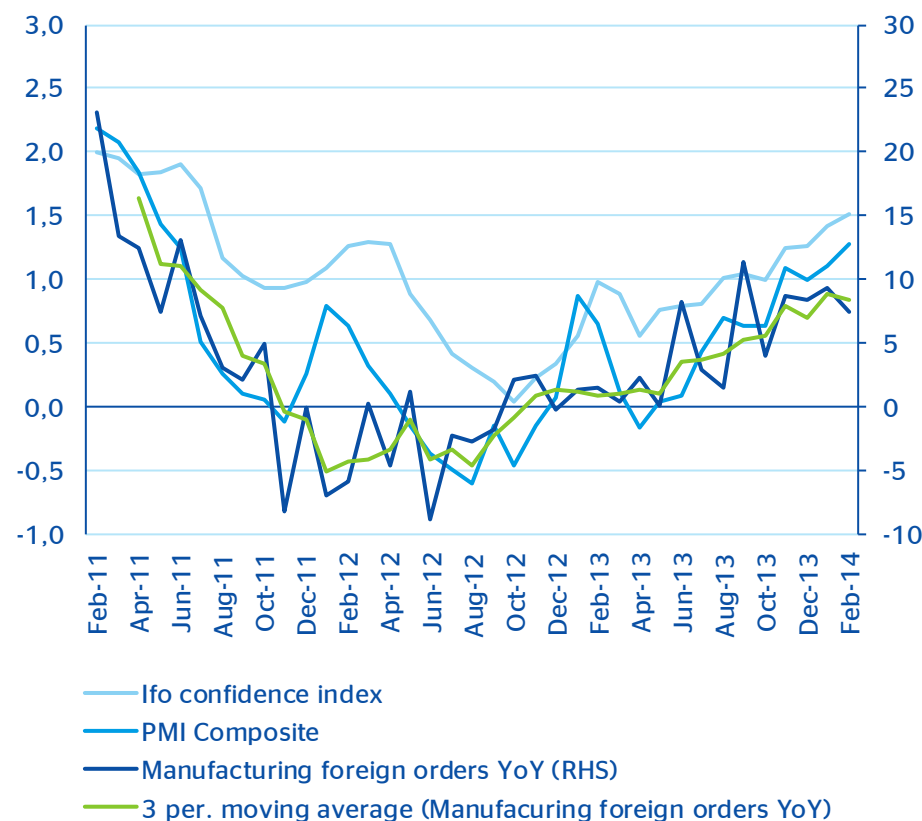
Robust growth with increasing role of domestic demand

| | 2012 | 2013 | 2014 (f) | 2015 (f) |
|-------------------------------------------|------|------|----------|----------|
| Economic activity | | | | |
| REAL GDP (yoy %) | 0.9 | 0.5 | 1.8 | 2.0 |
| Private Cons. | 0.7 | 1.0 | 1.4 | 1.6 |
| Public Cons. | 1.0 | 0.7 | 1.3 | 0.9 |
| Investment | -1.3 | -0.5 | 4.2 | 5.0 |
| Domestic Demand (contribution to %) | -0.2 | 0.5 | 1.8 | 1.9 |
| Exports | 3.8 | 1.0 | 3.6 | 3.9 |
| Imports | 1.8 | 1.0 | 4.2 | 4.5 |
| External Demand (contribution to %) | 1.1 | 0.0 | 0.0 | 0.0 |
| External sector | | | | |
| Current Account Balance (% GDP) | 7.0 | 7.5 | 6.7 | 7.0 |
| Public finance | | | | |
| General Government balance (% GDP) | 0.2 | 0.0 | 0.0 | 0.0 |
| Prices | | | | |
| CPI , % avg | 2.1 | 1.6 | 1.3 | 1.6 |

Germany: Healthy growth with medium-term concerns

Ifo confidence index, Composite PMI and Manufacturing foreign orders

BBVA Research

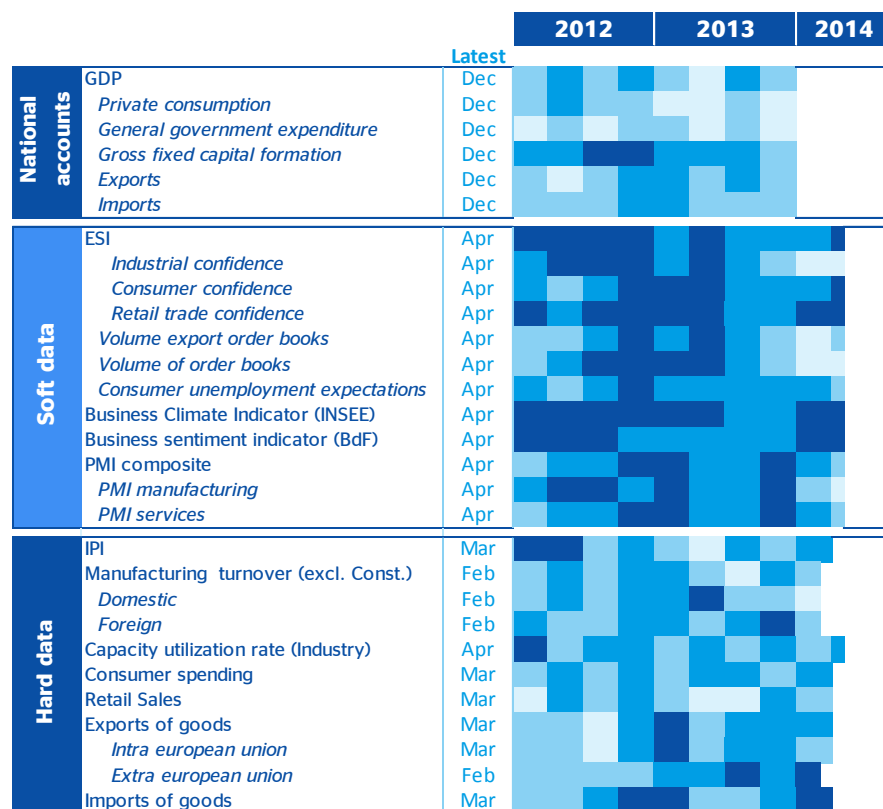


The growth pace is stronger and more balanced than in the other main economies

But the recent approval of a high minimum wage (€/h 8.50), effective from 2016, poses medium term risks for employment

Liberalization of some services sectors would help to prop up consumption and domestic growth

France: the recovery does not gain momentum



Based on quarterly growth rates. For the latest data, the average of available months in the quarter is taken.

For confidence data, standardized values are used, and the growth and fall are related to the mean.



Business confidence indicators stalled in the last few months

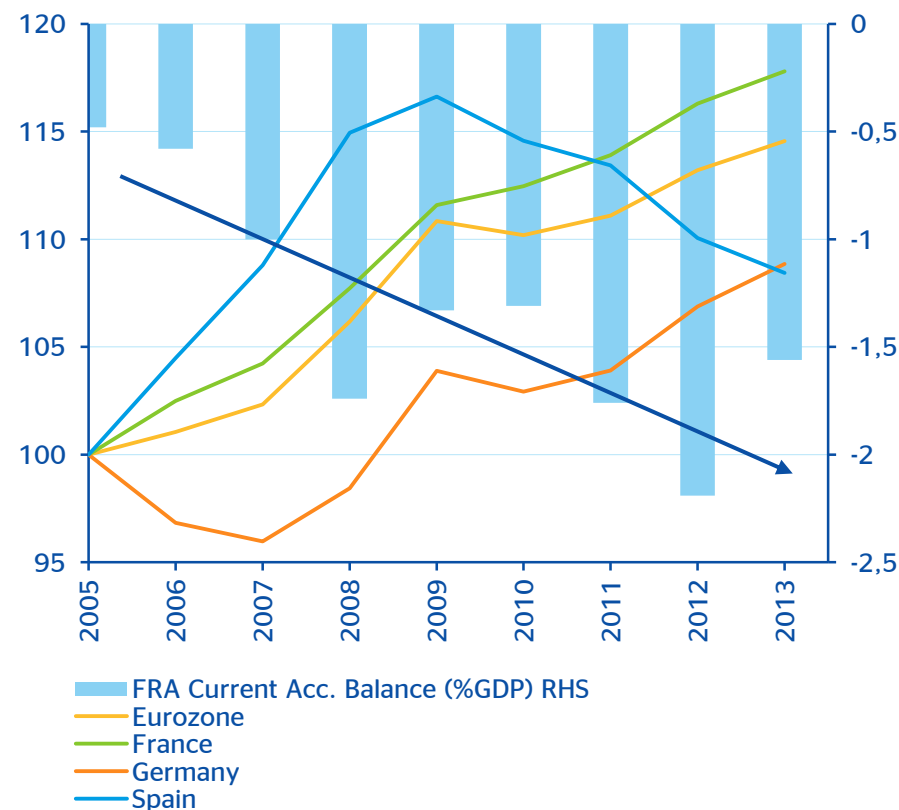
Slow recovery mainly driven by domestic demand

| | 2012 | 2013 | 2014 (f) | 2015 (f) |
|-------------------------------------|------|------|----------|----------|
| Economic activity | | | | |
| REAL GDP (yoy %) | 0.0 | 0.3 | 0.9 | 1.5 |
| Private Cons. | -0.3 | 0.4 | 0.9 | 1.2 |
| Public Cons. | 1.4 | 1.8 | 0.6 | 0.5 |
| Investment | -1.2 | -2.1 | 1.5 | 2.5 |
| Domestic Demand (contribution to %) | -0.9 | 0.4 | 0.9 | 1.3 |
| Exports | 2.5 | 0.7 | 1.9 | 3.2 |
| Imports | -0.9 | 1.0 | 1.8 | 2.6 |
| External Demand (contribution to %) | 1.0 | -0.1 | 0.0 | 0.1 |
| External sector | | | | |
| Current Account Balance (% GDP) | -2.3 | -1.6 | -1.7 | -1.6 |
| Public finance | | | | |
| General Government balance (% GDP) | -4.8 | -4.3 | -3.8 | -3.0 |
| Prices | | | | |
| CPI , % avg | 2.2 | 1.0 | 1.1 | 1.2 |

France: Reforms needed to regain competitiveness

Unit labour costs (2005=100) and Current account balance

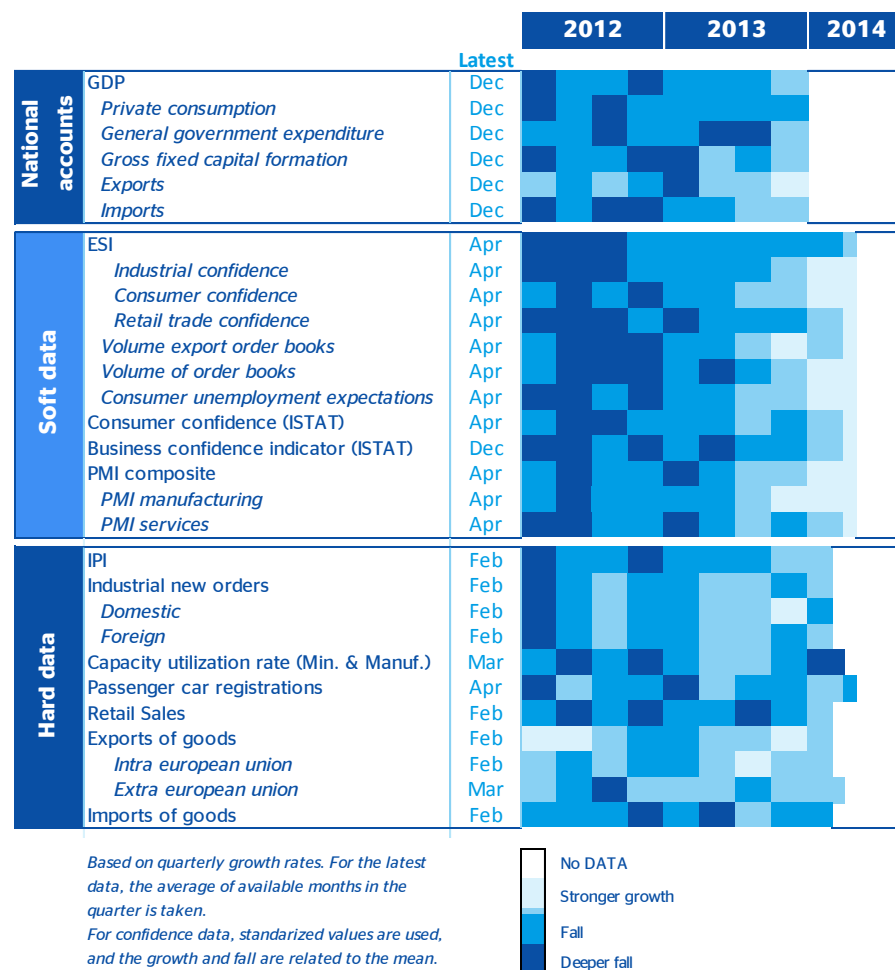
Source: BBVA Research



Loss of competitiveness is the main medium-term issue

Hence, cuts in employment taxes to be financed by lower public spending are expected

Italy: Exports support a slow recovery



Recent confidence indicators are clearly more upbeat

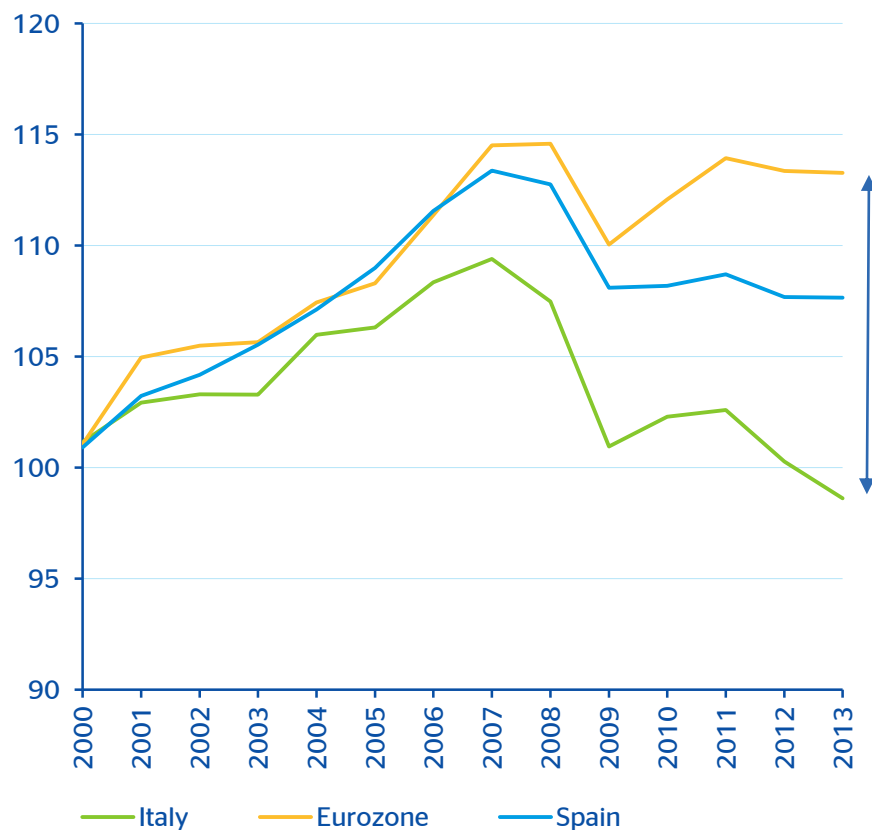
Out of recession since 4Q13, on the path of an export-driven recovery

| | 2012 | 2013 | 2014 (f) | 2015 (f) |
|-------------------------------------------|------|------|----------|----------|
| Economic activity | | | | |
| REAL GDP (yoy %) | -2.4 | -1.8 | 0.7 | 1.4 |
| Private Cons. | -4.0 | -2.6 | 0.1 | 1.2 |
| Public Cons. | -2.6 | -0.8 | -0.6 | 0.5 |
| Investment | -8.1 | -4.6 | 1.2 | 2.4 |
| Domestic Demand (contribution to %) | -5.0 | -2.6 | 0.2 | 1.3 |
| Exports | 2.0 | 0.0 | 3.3 | 3.6 |
| Imports | -7.1 | -2.9 | 1.9 | 3.5 |
| External Demand (contribution to %) | 2.6 | 0.8 | 0.5 | 0.2 |
| External sector | | | | |
| Current Account Balance (% GDP) | -0.7 | 0.8 | 1.1 | 0.9 |
| Public finance | | | | |
| General Government balance (% GDP) | -2.8 | -3.0 | -2.6 | -2.0 |
| Prices | | | | |
| CPI , % avg | 3.3 | 1.3 | 0.7 | 1.2 |

Italy: Reforms needed to increase growth potential

GDP / Working Age Population (2000=100)

Source: BBVA Research

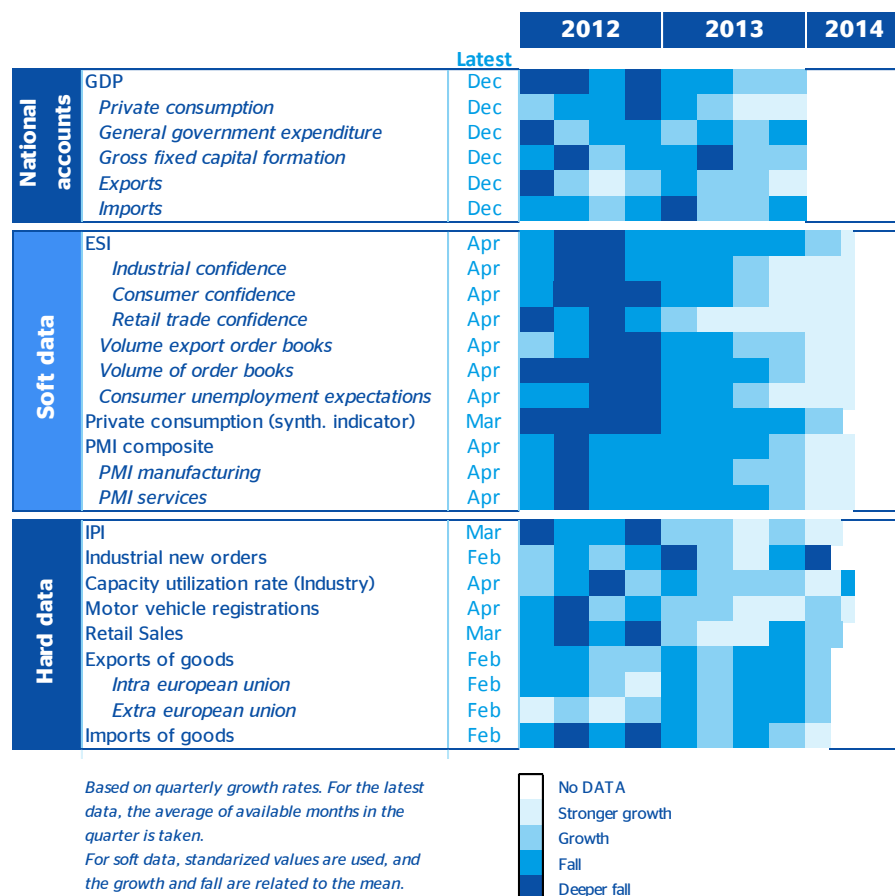


In fiscal policy, the main issue is the high volume of public debt (132,6%), while the deficit seems to be under control (-3%)

Very low potential growth reflects lack of reforms over a long period

Many reform initiatives have been launched, but need to be defined

Spain: The recovery is gaining traction



Soft and hard indicators have been gaining traction over the first months of Q4

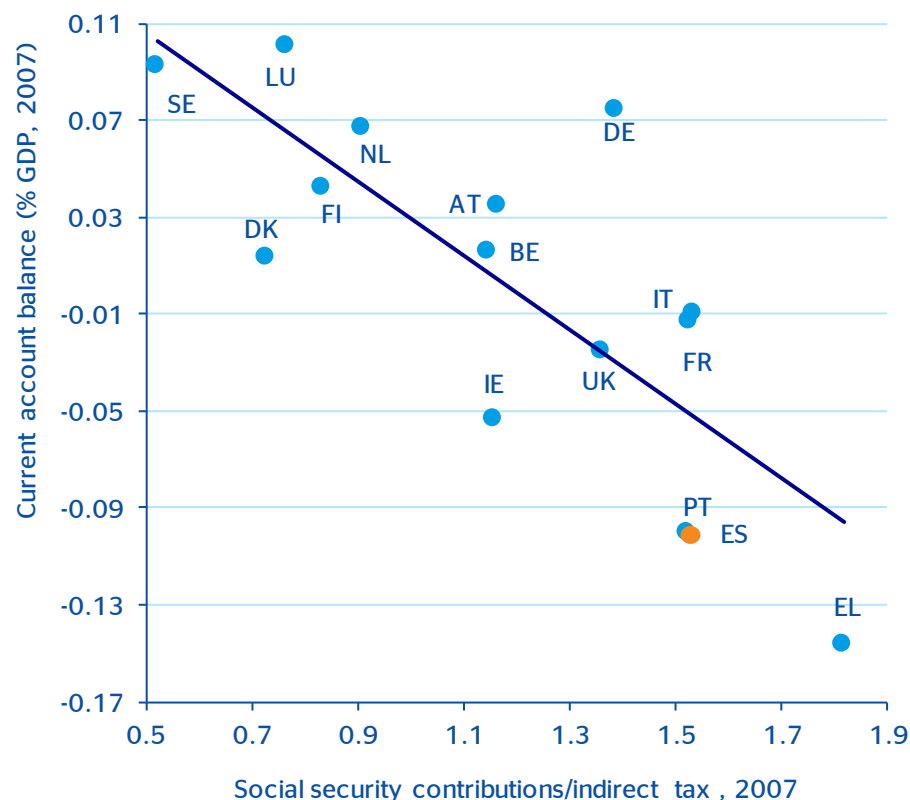
Growth projections at 1.1% and 1.9% in 2014 and 2015, with an upward bias this year

| | 2012 | 2013 | 2014 (f) | 2015 (f) |
|-------------------------------------------|------|------|----------|----------|
| Economic activity | | | | |
| REAL GDP (yoy %) | -1.6 | -1.2 | 1.1 | 1.9 |
| Private Cons. | -2.8 | -2.1 | 1.4 | 1.3 |
| Public Cons. | -4.8 | -2.3 | -1.6 | 1.4 |
| Investment | -6.9 | -5.2 | 1.0 | 4.5 |
| Domestic Demand (contribution to %) | -4.1 | -2.7 | 0.7 | 1.9 |
| Exports | 2.1 | 4.9 | 6.0 | 5.1 |
| Imports | -5.7 | 0.4 | 5.4 | 5.4 |
| External Demand (contribution to %) | 2.5 | 1.5 | 0.4 | 0.0 |
| External sector | | | | |
| Current Account Balance (% GDP) | -1.2 | 0.8 | 1.3 | 1.5 |
| Public finance | | | | |
| General Government balance (% GDP) | -6.8 | -6.6 | -5.8 | -5.1 |
| Prices | | | | |
| CPI , % avg | 2.4 | 1.4 | 0.3 | 0.9 |

Spain: Reforms needed to reduce unemployment and consolidate competitiveness gains

EU 15: current account balance and implicit Social Security contribution rates

Source: BBVA Research based on based on Boscá, Doménech and Ferri (2013)



Fiscal devaluation: the optimum alternative

Recent cut in Social Security Contributions (SSC) will have a positive impact on GDP and employment..

... but limited due to the temporary nature of the measure (among other factors)

A fiscal devaluation (increase indirect taxes + reduction of SSC) may improve price-competitiveness, employment and activity

Europe Economic Outlook

May 2014