



# Europe Economic Outlook

---

August 2010

## Main messages

### Global Economic Outlook

### Reassessing the risks for the global economy

- The main risk to the global outlook is still coming from financial markets. Stress tests have had positive – though asymmetric – impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable.
- The global economy is on track for a mild and differentiated slowdown. In China and elsewhere in Asia, a moderating growth trend should reduce the risk of overheating. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis.
- Increasing divergence in monetary policy strategies. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America.

## Main messages

### Europe Economic Outlook

Economic  
recovery on  
track, but  
uncertainty  
remains

- The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated.
- There have been some progress with the publication on stress tests, although bank re-structuring is far from complete
- Domestic demand is still subdued, with flat private consumption and further fall in investment, while public consumption slows.
- Our medium term scenario, after the good performance in the first two quarters of 2010, anticipates a slowdown in activity during the second half and mild growth in 2011
- Across countries, Germany will continue to be above average, while South European countries will perform worse
- Monetary policy to remain adequately accommodative at least until early 2012
- On the fiscal front, well designed austerity plans can limit their effect on activity if accompanied by structural reforms.

## Contents

### Europe Economic Outlook

Section I

## Reassessing the risks for the global economy

Section II

Forces shaping the recovery

Section III

Recent trends and projections

Sección IV

Inflation and ECB rates

Sección V

The effects of fiscal tightening

## Reassessing the risks for the global economy

### Global Economic Outlook

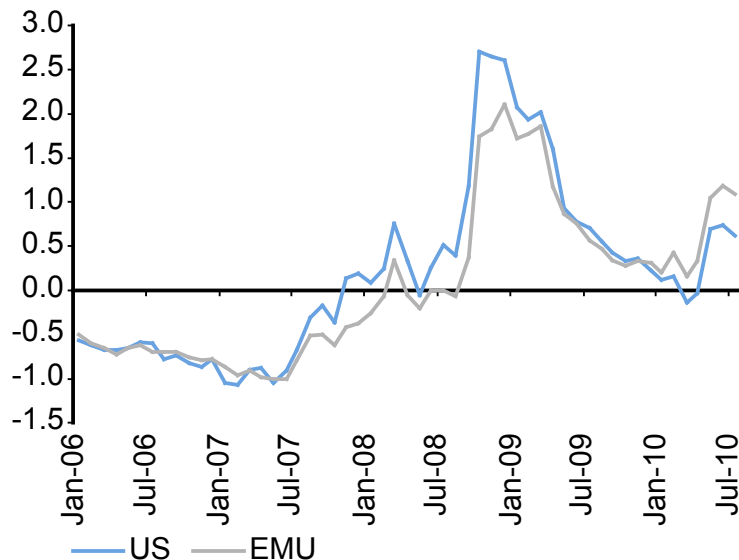
### Reassessing the risks for the global economy

The main risk to the global outlook is still coming from financial markets. Nevertheless the financial tensions that took place during the second quarter started to abate.

Across regions, there are differences in growth prospects. China and the rest of Asia are reducing the risks of overheating thanks to the authorities tightening measures. In Latin America growth will slowdown in 2011 but keep robust afterwards. In the US the recovery is likely to lose momentum.

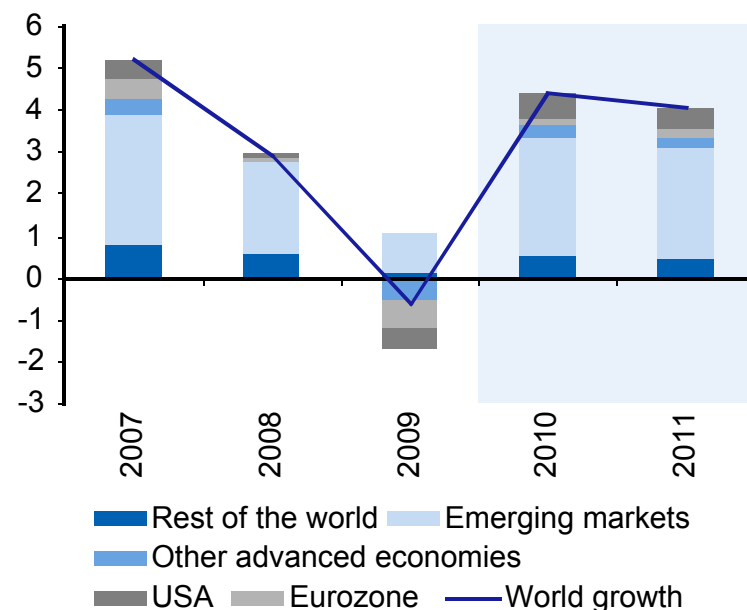
#### Financial stress index

Source: Eurostat and European Commission



#### Contribution to global GDP growth

Source: Eurostat



## Contents

Section I

Reassessing the risks for the global economy

Section II

## Forces shaping the recovery in Europe

Section III

Recent trends and projections

Sección IV

Inflation and ECB rates

Sección V

The effects of fiscal tightening

## Forces shaping the recovery in Europe

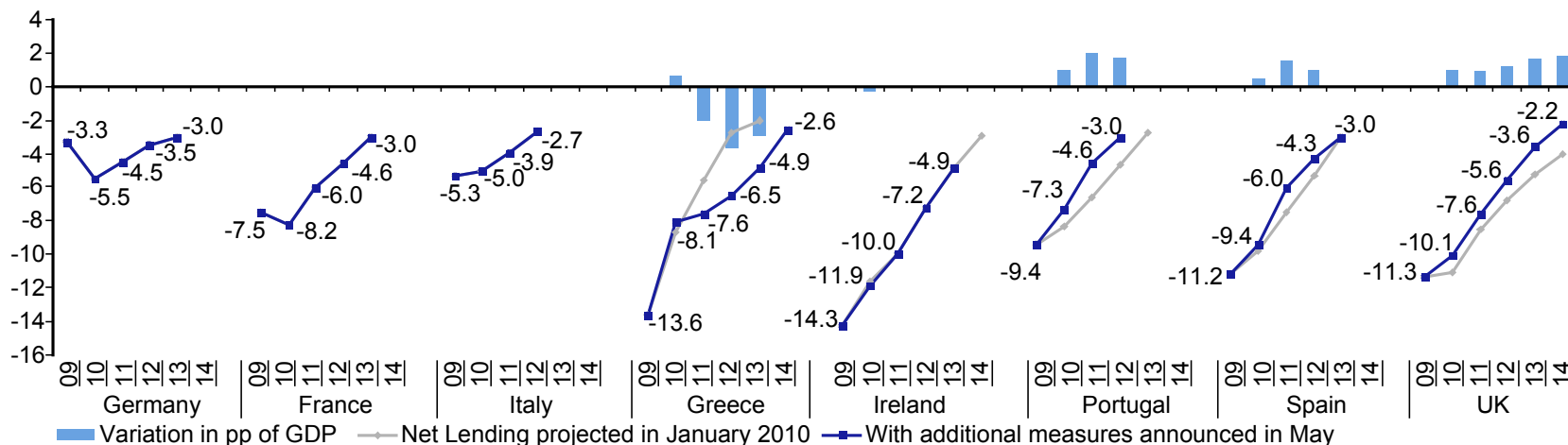
### Europe Economic Outlook

**Fiscal austerity plans** as designed at the end of 2010 and approved by Brussels are being fulfilled, together with the discussions for the 2011 budget. Germany, France and Italy disclosed the details but the path of consolidation did not change. On the contrary, Spain, Portugal and the UK had frontload their fiscal effort.

The **sovereign crisis** hit several eurozone countries since May leading to an increase in financial stress. Although the situation improved after the publication of stress tests, we expect that impact on confidence, risk aversion and liquidity will drag on economic growth.

### Europe: Deficit targets

Source: Eurostat and European Commission



## Forces shaping the recovery in Europe

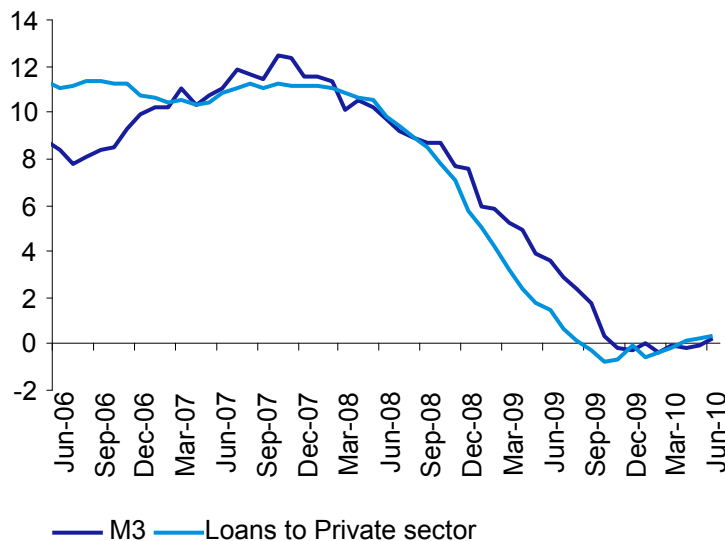
### Europe Economic Outlook

The **restructuring of the financial system** will continue to be an issue, in spite of the publication of stress tests, as money and credit aggregates show weak signs of recovery. Without bank recapitalization and the ability to provide credit, a durable recovery will not be possible in the eurozone.

**The euro** depreciation partially reverted in the last month, but we still estimate that the equilibrium level lies at around 1.10 and 1.25. This will play in favor of exports.

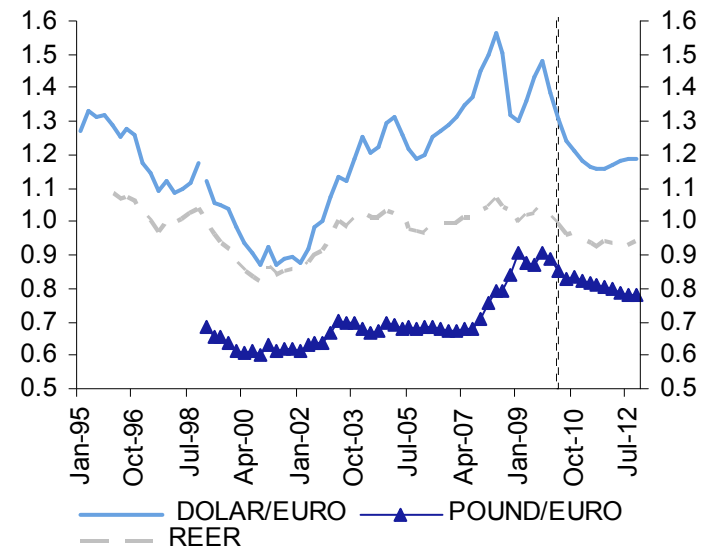
#### M3 and loans to private sector

Source: European Central Bank



#### Eurozone: Exchange rate

Source: BBVA Research





## Contents

### Europe Economic Outlook

Section I  
Reassessing the risks for the global economy

Section II  
Forces shaping the recovery in Europe

Section III  
**Recent trends and projections**

Sección IV  
Inflation and ECB rates

Sección V  
The effects of fiscal tightening

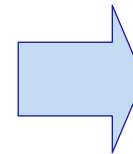
## Recent trends and projections

### Europe Economic Outlook

### Strong performance in Q2

The Eurozone will grow strongly in Q2, but several indicators suggest that the recovery is fading

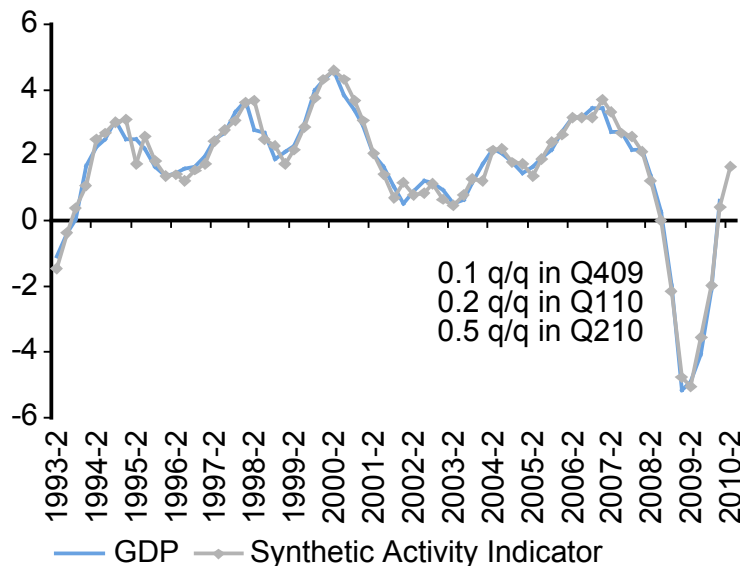
Our **synthetic activity indicator** points to a growth of 0.5% q/q, after a mild improvement in previous quarters. The key question lies on its sustainability in the second semester



- (1) **confidence data** and **leading indicators** have eased
- (2) **fiscal stimulus** programs are being terminated and,
- (3) the strong **inventory rebuilding** to compensate the weakness of domestic demand is fading

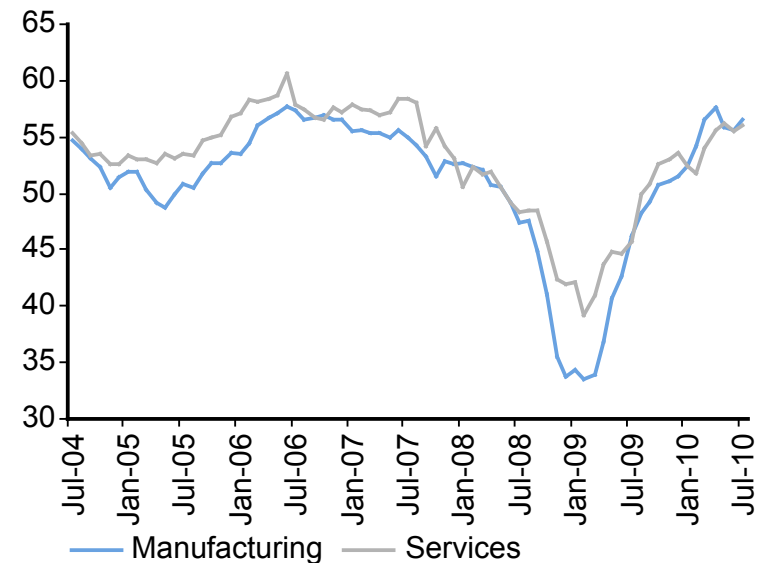
### Eurozone: Synthetic Activity Indicator

Source: Eurostat and European Commission



### Eurozone: Sentiment from PMI surveys

Source: Markit



## Recent trends and projections

### Europe Economic Outlook

Domestic  
demand is  
still subdued

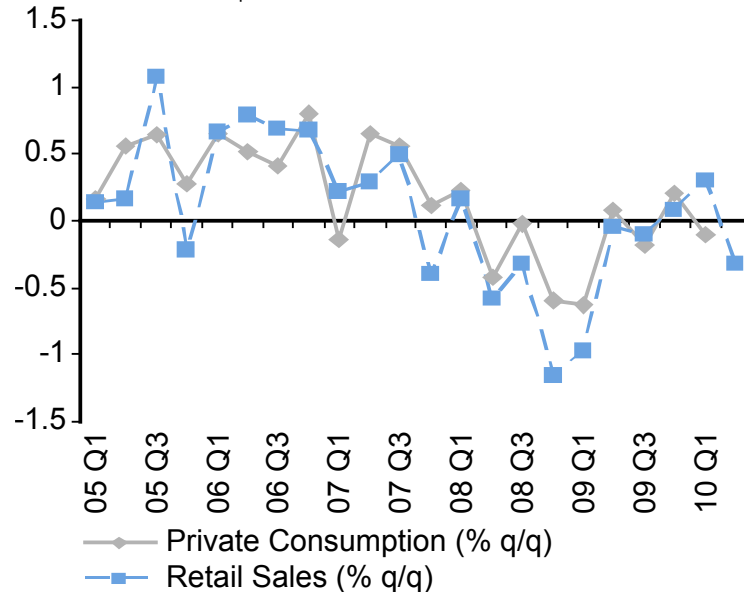
Private consumption is flat, investment continues to fall and public consumption is slowing

The improvement of consumer confidence should reflect a reduction in precautionary savings while the end fiscal stimulus will push in the opposite direction. The weakness of private consumption is widespread across large countries.

Recent data showed that retail sales in the eurozone in Q2 remained flat

#### Eurozone: Households' consumption

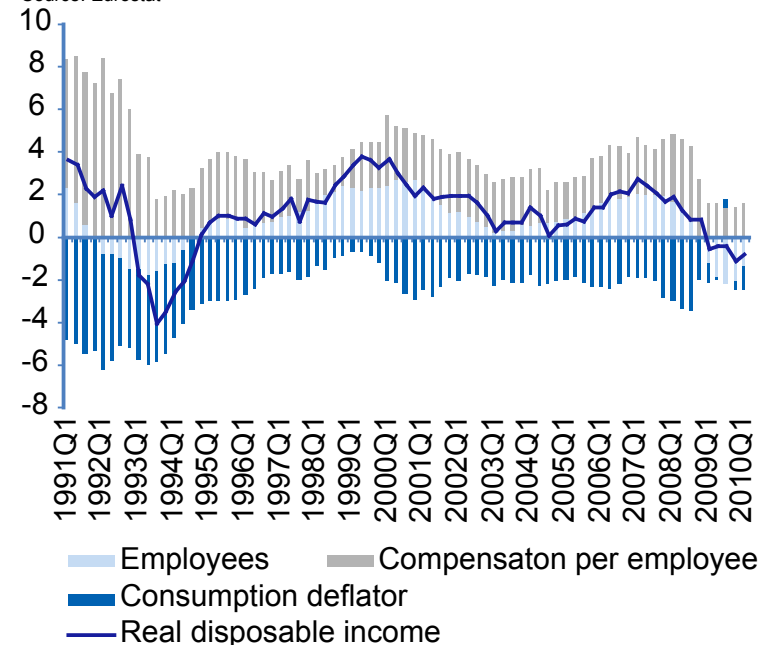
Source: Eurostat and European Commission



The weakness of household spending is explained by the drop in disposable income

#### Eurozone: Households' disposable income

Source: Eurostat



## Recent trends and projections

### Europe Economic Outlook

Domestic  
demand is  
still subdued

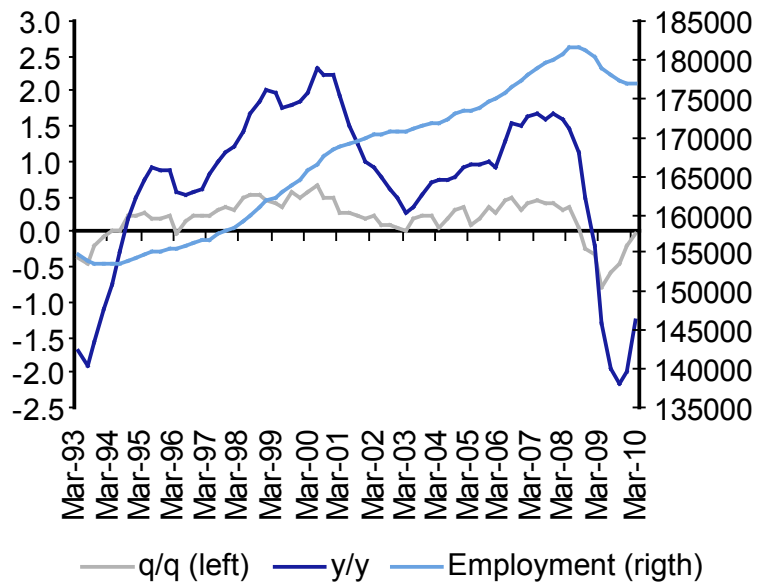
The **labour market** deterioration leveled off in Q2, while hiring intentions improved

Employment was flat in Q1 after falling for 6 consecutive quarters.

Across countries, the divergence has been significant. In Germany unemployment fell thanks to the short-term scheme and the recovery of industrial production

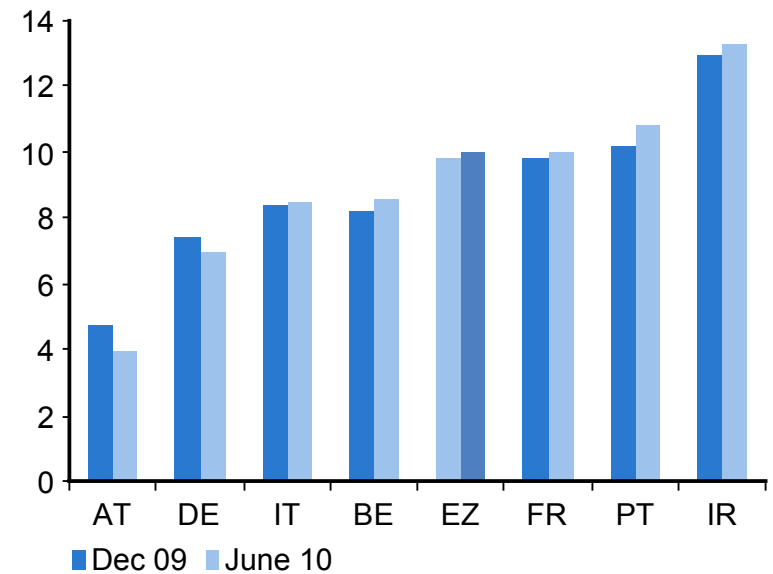
### Eurozone: Employment

Source: Eurostat and BBVA Research



### Eurozone: Unemployment rate

Source: Eurostat



## Recent trends and projections

### Europe Economic Outlook

Industrial output has been strong recently but doubts for the near future are rising. **Investment** has been falling as capacity of utilization is low, while **inventories build-up** is more unlikely to add much more to output.

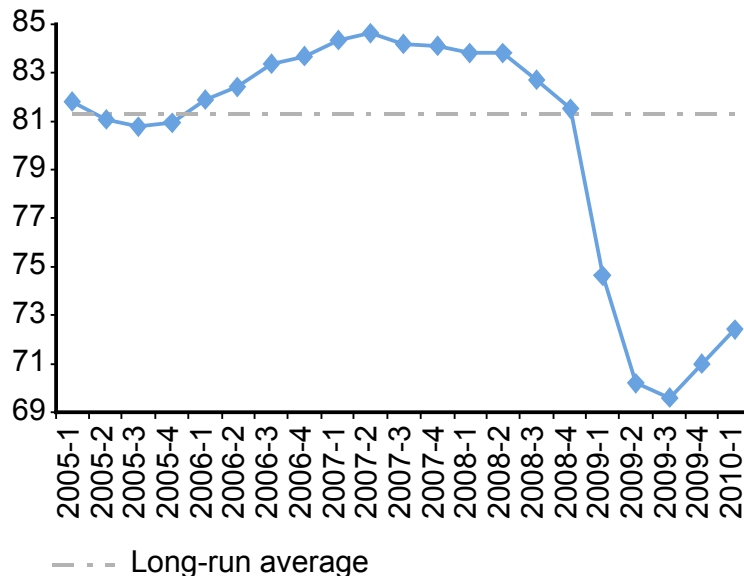
### Exports rebound

With capacity of utilization at low levels, firms can cope with the increased demand without the need to invest further

Exports recovered about 85% of the drop during the recession, but the growth in imports will partially offset the contribution to growth of next exports

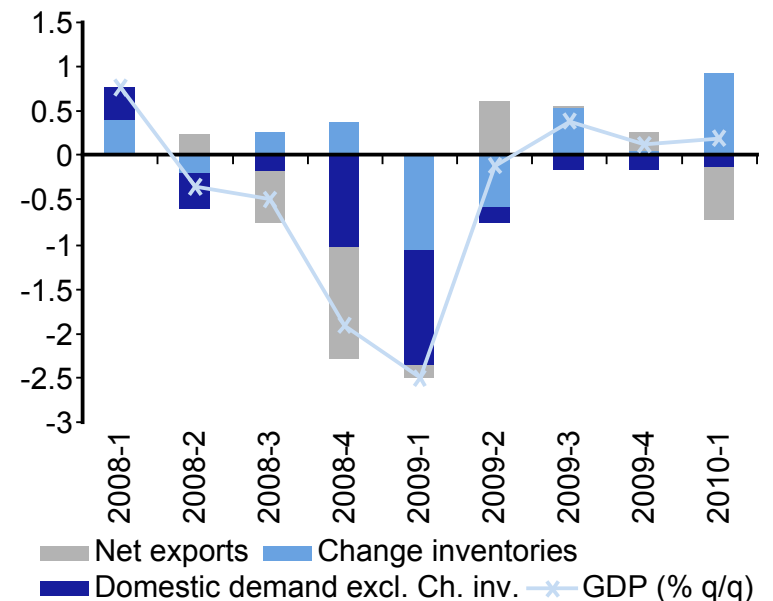
### Eurozone: Capacity of utilization

Source: Eurostat and BBVA Research



### Eurozone: contribution to quarterly GDP growth

Source: Eurostat



## Recent trends and projections

### Europe Economic Outlook

Medium term  
slowdown  
and a mild  
recovery in  
2011.

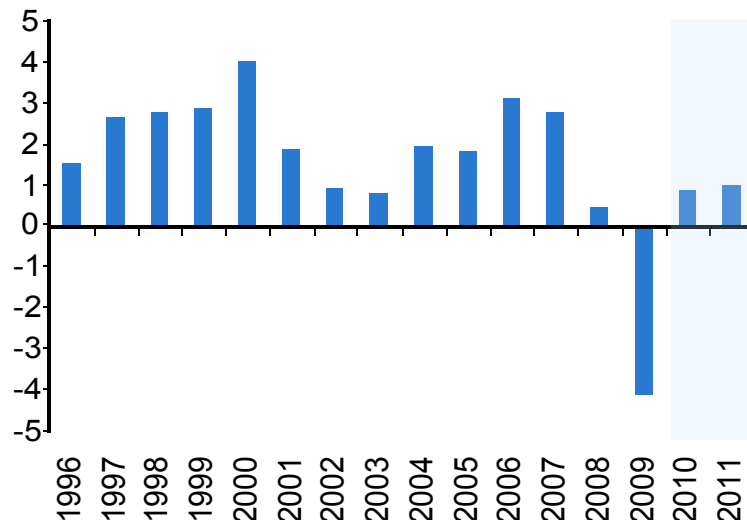
The composition of growth will be tilted towards exports and will be accentuated by the low value of the euro and the fiscal adjustment.

Fiscal austerity and financial stress will put a break to an eventual recovery of domestic demand.

Our projection for the eurozone is around 1% for both 2010 and 2011, but hiding important disparities both in terms of the two halves of 2010 and across countries

#### Eurozone: GDP growth

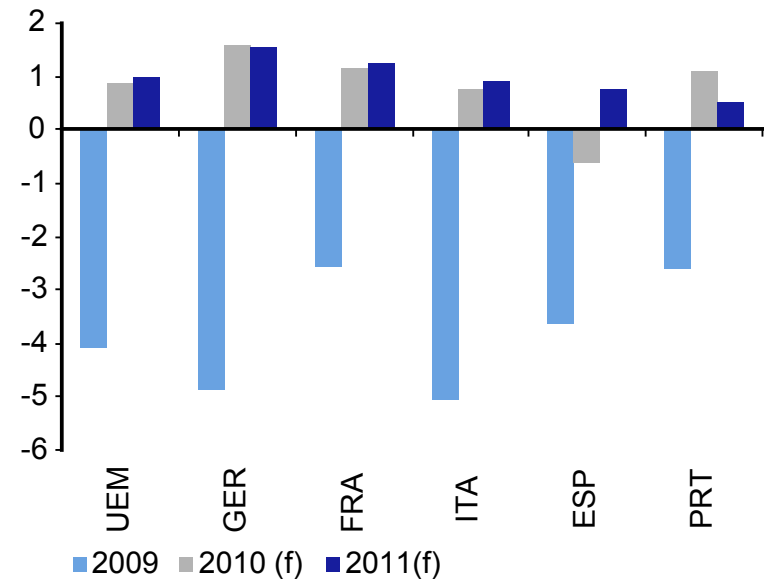
Source: Eurostat and BBVA Research



Germany will continue to grow above average, while south Europe will perform worse

#### Eurozone: GDP growth by countries

Source: Eurostat



## Recent trends and projections

GDP growth (% q/q)	2007	2008	2009	2010	2011	2008				2009				2010			
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Private Consumption	1.6	0.3	-1.2	0.0	0.4	0.2	-0.4	0.0	-0.6	-0.6	0.1	-0.2	0.2	-0.1	0.0	0.0	0.1
Public Consumption	2.3	2.2	2.7	1.0	0.5	0.5	0.8	0.5	0.8	0.7	0.7	0.7	0.0	0.6	0.0	-0.1	-0.2
Investment	4.6	-0.9	-10.9	-3.4	0.3	0.6	-1.4	-1.2	-4.0	-5.1	-1.7	-1.0	-1.3	-1.1	-0.2	-0.3	-0.4
Change inventories (1)	0.0	0.1	-0.8	1.0	0.0	0.4	-0.2	0.3	0.4	-1.1	-0.6	0.5	0.1	0.9	-0.1	0.0	0.0
<b>Domestic Demand (1)</b>	<b>2.4</b>	<b>0.5</b>	<b>-3.3</b>	<b>0.5</b>	<b>0.4</b>	<b>0.8</b>	<b>-0.6</b>	<b>0.1</b>	<b>-0.7</b>	<b>-2.4</b>	<b>-0.7</b>	<b>0.4</b>	<b>-0.1</b>	<b>0.8</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-0.1</b>
Exports	6.3	0.7	-13.2	7.7	7.9	1.8	-0.5	-1.2	-7.3	-8.4	-1.1	2.8	1.7	2.5	2.0	1.4	1.5
Imports	5.5	0.8	-11.9	6.9	6.7	1.9	-1.1	0.1	-4.7	-8.1	-2.7	2.8	1.2	4.0	0.7	0.9	0.9
<b>Net Exports (1)</b>	<b>0.4</b>	<b>0.0</b>	<b>-0.8</b>	<b>0.4</b>	<b>0.6</b>	<b>0.0</b>	<b>0.2</b>	<b>-0.6</b>	<b>-1.2</b>	<b>-0.1</b>	<b>0.6</b>	<b>0.0</b>	<b>0.2</b>	<b>-0.6</b>	<b>0.6</b>	<b>0.2</b>	<b>0.3</b>
<b>GDP</b>	<b>2.8</b>	<b>0.4</b>	<b>-4.1</b>	<b>0.9</b>	<b>1.0</b>	<b>0.8</b>	<b>-0.4</b>	<b>-0.5</b>	<b>-1.9</b>	<b>-2.5</b>	<b>-0.1</b>	<b>0.4</b>	<b>0.3</b>	<b>0.2</b>	<b>0.4</b>	<b>0.1</b>	<b>0.1</b>

(1) Contribution to GDP growth

GDP growth by countries (% y/y)	2007	2008	2009	2010	2011
EMU	2.8	0.4	-4.1	0.9	1.0
Germany	2.6	1.0	-4.9	1.6	1.5
France	2.3	0.1	-2.5	1.2	1.3
Italy	1.4	-1.3	-5.1	0.7	0.9
UK	2.7	-0.1	-4.8	1.4	1.7

Source: Eurostat and BBVA Research

## Contents

### Europe Economic Outlook

Section I  
Reassessing the risks for the global economy

Section II  
Forces shaping the recovery

Section III  
Recent trends and projections

Sección IV

## Inflation and ECB rates

Sección V  
The effects of fiscal tightening



## Inflation and ECB rates

### Europe Economic Outlook

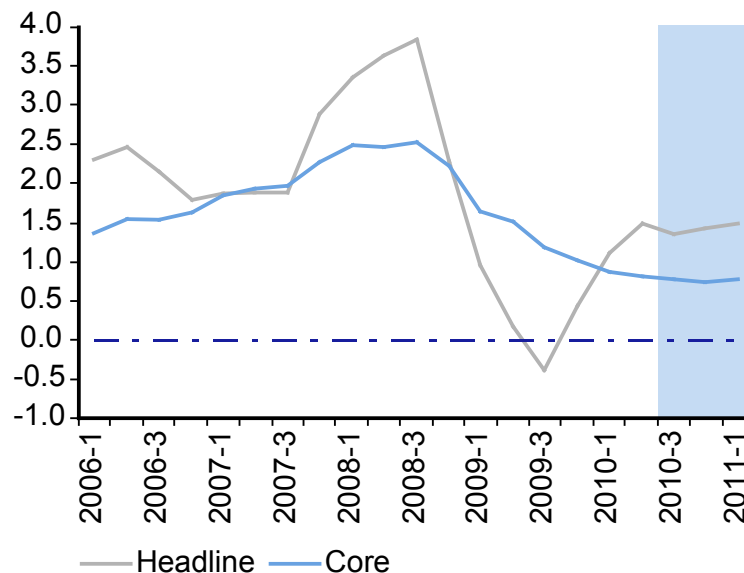
Headline **inflation** accelerated in Q2 driven by energy prices, while core inflation remained broadly stable. This reacceleration in prices has been an upward surprise. For the second half of the year it will remain stable reflecting the moderation in economic activity offsetting the effect of price increases due to VAT hikes.

On the **ECB** front, the activation of the Securities Markets Program have been diminishing. We foresee that it will keep committed to further mitigate liquidity tensions if necessary.

Inflation is expected to remain well under  
ECB's target

#### Eurozone: Inflation

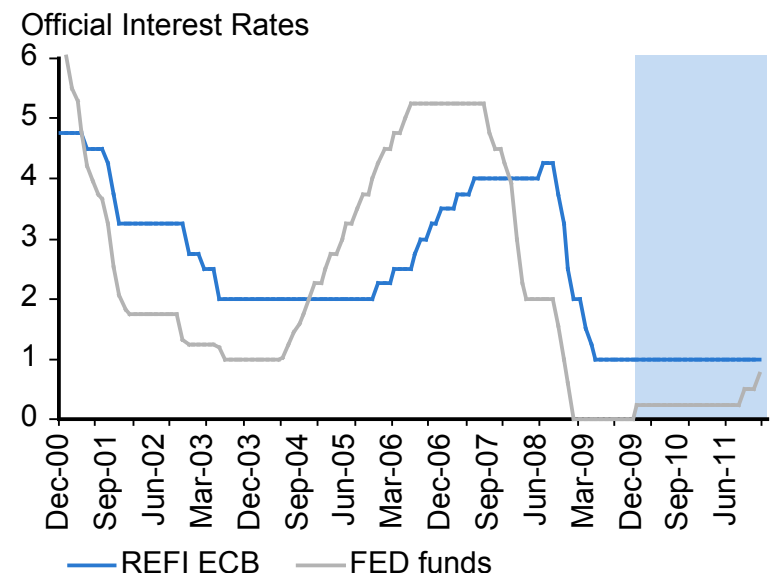
Source: Eurostat and BBVA Research



interest rates will be kept on hold until the end  
of 2011

#### Eurozone: Official interest rates

Source: Eurostat



## Contents

### Europe Economic Outlook

Section I  
Reassessing the risks for the global economy

Section II  
Forces shaping the recovery

Section III  
Recent trends and projections

Sección IV  
Inflation and ECB rates

Sección V  
**The effects of fiscal tightening**

## The effects of fiscal tightening

### Europe Economic Outlook

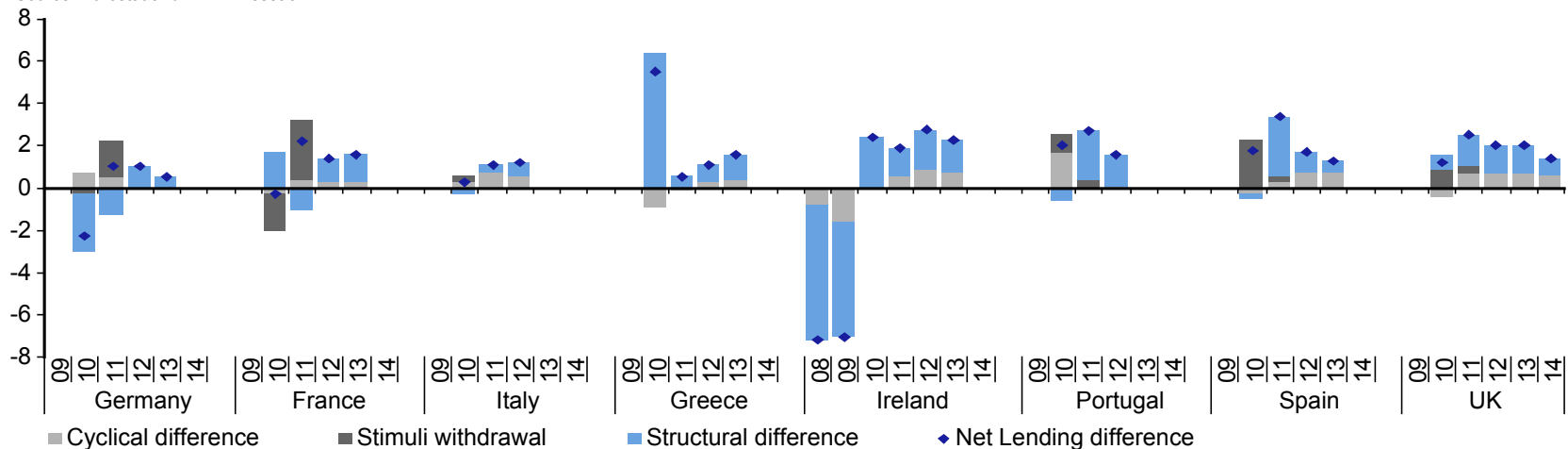
Negative  
effect of  
fiscal  
consolidation  
on European  
activity will  
be lower  
than  
commonly  
assumed

The fiscal situation has deteriorated rapidly in many EU countries, but not only due to the stimulus. There has been an important deterioration of the structural component.

Consolidation plans in Europe are being implemented according to the schedules presented to the EC at the beginning of 2010. Except for Spain, Portugal and the UK, that decided to frontload the fiscal adjustment.

### Eurozone: Size and composition of consolidation

Source: Eurostat and BBVA Research



## The effects of fiscal tightening

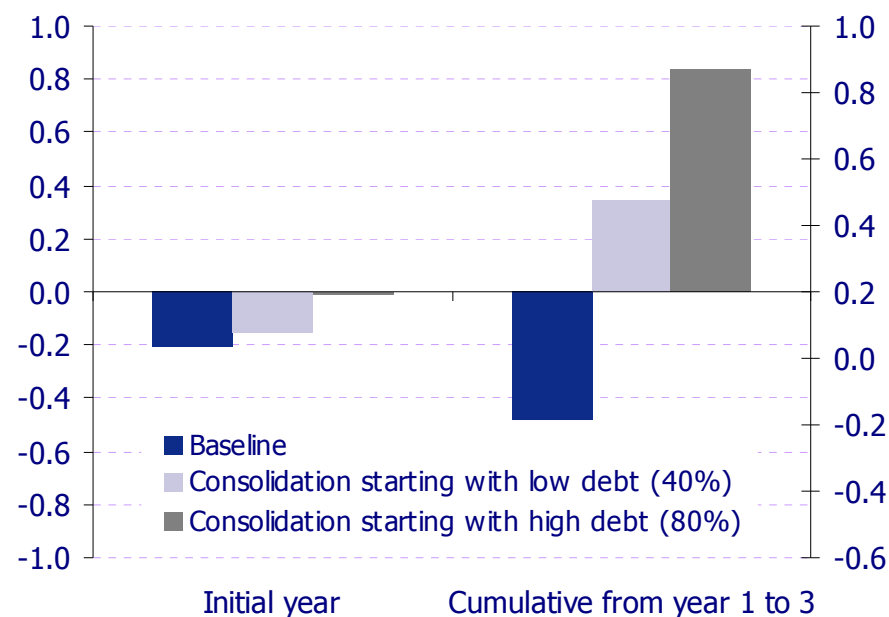
### Europe Economic Outlook

Negative  
effect of  
fiscal  
consolidation  
on European  
activity will  
be lower  
than  
commonly  
assumed

- The experience of past fiscal consolidations shows that its negative impact on economic activity is lessened when:
  1. It is accompanied by structural reforms
  2. It is sizable and perceived as permanent, thus increasing credibility
  3. It relies more heavily on reducing expenditures than increasing taxes
  4. The country starts from an already weak macroeconomic position, for example, high and increasing levels of public debt.
- In the long run, decisive fiscal consolidations boost growth.

### Response of GDP growth to an increase of cyclically adjusted primary surplus of 1pp of GDP

Source: BBVA Research



## The effects of fiscal tightening

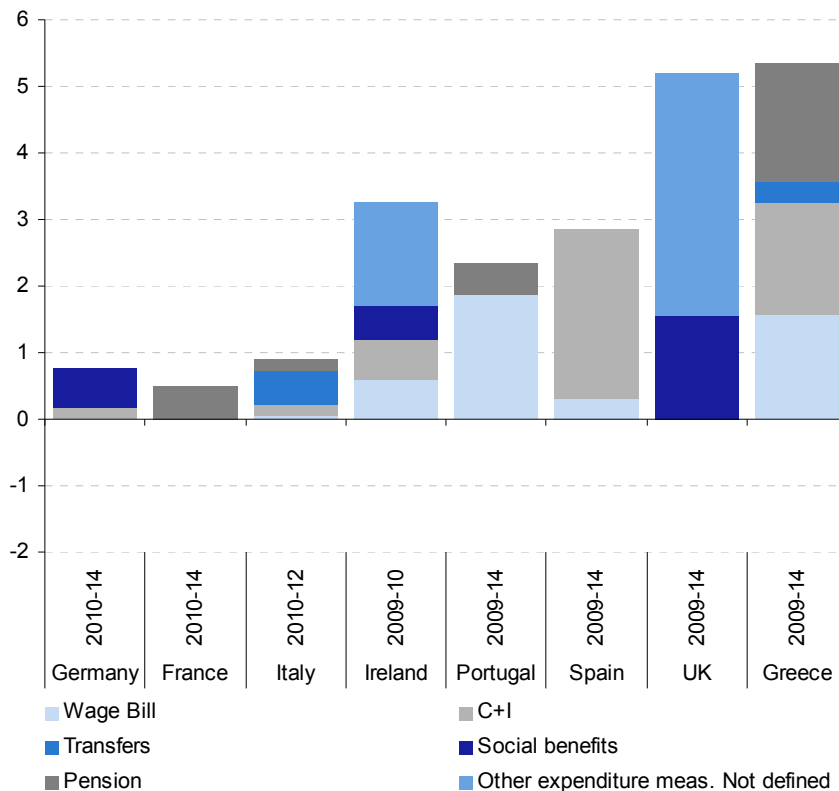
### Europe Economic Outlook

Negative  
effect of  
fiscal  
consolidation  
on European  
activity will  
be lower  
than  
commonly  
assumed

- Fiscal consolidation in Europe is fast and tilted towards reducing expenditure.
- Therefore, given past experiences, as long as the determination on fiscal consolidation is maintained, the negative impact on European economic activity will be limited and transitory.

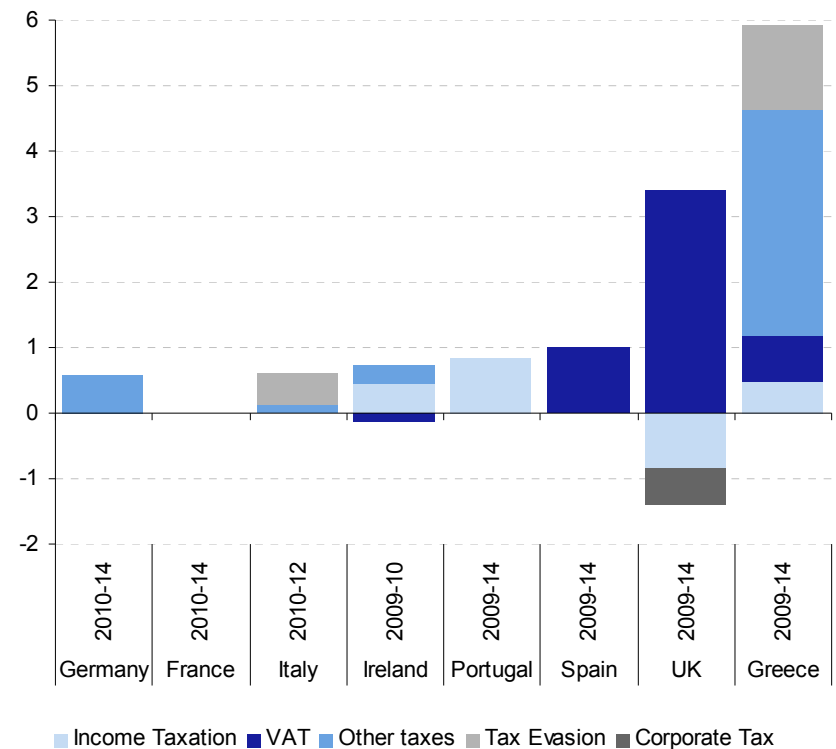
#### All detailed expenditure measures as % of GDP

Source: BBVA Research



#### All detailed revenue measures as % of GDP

Source: BBVA Research





# Europe Economic Outlook

---

August 2010