MACROECONOMIC ANALYSIS

Robust growth, but low inflation and downside risks to activity will delay interest-rate hikes

Europe Unit

The normalisation of monetary policy may be delayed to the third quarter of 2015, until the figures can assuage doubts about the increase in prices and wages

Solid and stable growth continued into 3Q14, sustained by the strength in private domestic spending…

Preliminary 3Q14 data estimate that GDP grew 0.7% QoQ (similar to the rate since the beginning of 2013, but decelerating a little from its peak of 0.9% QoQ in 2Q14), with the services sector as the main driver of growth (making a contribution of 0.6pp [percentage points], with its 0.7% QoQ growth) and, to a lesser degree, the industrial and construction sectors (contributing between them around 0.1pp with increases of 0.5% QoQ and 0.8% QoQ respectively), with zero contribution from agriculture.

Although the breakdown of GDP on the demand side has not yet been published, the above figures, together with other available data, suggest that domestic demand is, once again, behind this robust growth (Figures 1 and 6), of both private consumption (despite a certain moderation in the growth of retail sales) and investment, which is presenting a rather more solid rate of progress (in line with the increase in the production of intermediate and durable consumer goods). When it comes to the external sector, the balance of trade and current account figures suggest that net exports could have drained away some of the growth (after the increasingly smaller contribution in previous quarters, from around 0.5pp in 4Q13 and 1Q14 right down to a zero contribution in 2Q14), given that nominal exports contracted again (-0.3% QoQ in 3Q14), while imports expanded slightly (0.6% QoQ after their sharp falls in earlier quarters) (Figures 7 and 8).

… with strong job creation and initial signs of wage and productivity increases …

Employment creation continued apace in the second and third quarters (0.5% QoQ and 0.4% QoQ respectively), although moderating somewhat from the rates of the previous 12 months (0.7% QoQ on average); furthermore, the improvement was due to the creation of full-time, waged jobs, as opposed to the increase in self-employed and part-time occupations in the preceding quarters. This development in the job market was a result of an increase in productivity (0.4% QoQ and 0.3% QoQ respectively, after having stagnated at the end of last year), while the change in composition in employment creation may have been the cause of the recent increase in nominal wages. In addition, the confidence surveys are also indicating that wages may continue to rise in the next few quarters. These figures help to resolve the paradox of the recent stagnation in productivity, and will be important for deciding the monetary policy stance in order to better assess the idle capacity in the economy.

… but inflation has continued to decelerate to very low levels, with no pressures in sight and with risks to the downside in the short term

Inflation slowed down again in the third quarter to 1.3% YoY in September (Figures 11 and 12), around half a point higher than forecast in the August Inflation Report (IR). The changes in food and energy prices are the main factors accounting for this deceleration, but the risks to the downside have increased, particularly in the short term, deriving from the fall in the oil price and the possible delay in the pass-through to consumer prices of the strong pound. In particular, these are the factors underlying the much more cautious tone of the November IR and which have weighed the heaviest in keeping interest rates unchanged, although the minutes from the November meeting show that the disagreements between committee members about the medium-term risks are on the rise. Some see risks to the downside caused by greater moderation in activity and believe that inflation could stay at very low levels for a prolonged period, whereas others see risks to the upside that might derive from a swifter reduction in the economy's idle capacity.

For the next few months, our forecasts suggest that inflation will remain close to current levels (1.2-1.3% YoY), before beginning to edge up around the middle of next year. In consequence, annual average inflation will be 1.5% in 2014 and 1.6% in 2015 (corrected -0.2pp and -0.1pp downwards from our estimates three months ago). The strength of the pound and the lower commodities prices are behind this revision scenario, together with the moderation in wage increases. The risks remain biased to the downside.

Hearty growth expected for 2014-15, underpinned by strong domestic demand, particularly in investment

In the last three months, domestic factors underlying economic performance have behaved in line with expectations (more employment, less inflation, continued improvement in confidence and in financing conditions, with the commitment of a continued accommodative economic policy). These will allow domestic demand to continue driving activity at solid rates throughout the forecast horizon, rather more strongly than was expected three months ago. Nevertheless, the deterioration in the outlook for global growth, particularly for the eurozone, may result in a zero contribution on the part of net exports.

In general, we are holding to our growth scenario from three months ago, although with rather more progress than expected in the third quarter (+0.9% QoQ), and the data available to date (together with some effects in the composition deriving from the new ESA2010 methodology for national accounts), have led us to correct our GDP growth forecast slightly upwards in 2014 and 2015 by 0.1pp and 0.2pp, to 3% and 2.7% respectively. As such, we still expect a slight moderation in growth in the coming quarters, although we continue to anticipate robust growth (around 0.6% a quarter on average throughout our forecast horizon), slightly above our growth potential estimate of around 2%.

The uptick in investment will be the main determinant for the major expansion in production, together with the resilience of private consumption, although we now expect a practically zero contribution from external demand (given the strength of sterling and the timid recovery of the eurozone). The expectations of low rates of interest for a long time, as well as better access to financing for companies, will continue to favour investment (around 8% in 2014 and 6.3% in 2015), especially since corporate realised capacity is already above its historic average. Meanwhile, job creation, as well as the increase in nominal wages (without wage pressures due to a rise in productivity) and a moderate rate of inflation, will have the consequence of increasing disposable household income, at the same time as the reduction in the rate of precautionary savings may continue. All this will be reflected in an increase in private consumption of a little over 2% in 2014 and 2015, although clearly below pre-crisis growth rates, due to the on-going process of debt reduction in the private sector.

After the neutral tone of fiscal policy this year, we are expecting a severe moderation in public consumption growth in 2015, in order to comply with the fiscal consolidation process which is underway. Net exports will make practically no contribution to GDP growth (0.0pp in 2014 and 0.1pp in 2015), since, despite the anticipated recovery of exports in 2015 (limited by the strength of sterling and a greater increase in domestic prices than in the eurozone), they will not grow much more than the purchases from abroad to satisfy domestic demand.

Finally, the job market is expected to continue the trend of improvement in the next few quarters, although the reduction in unemployment will be slower in coming quarters, partly as a result of the uptick in productivity, for which reason we expect the unemployment rate to stand at around 6% by the end of 2014 and a little above 5.5% in 2015.

Uncertainty about this scenario is still high. Together with the risks associated with the possible negative effects of normalising economic policy in an election year, as well as doubts about the economy's idle capacity, now there is also the possible cooling of the property market and the likely consequences of lower global growth, especially in the eurozone. This will not only have a direct effect along the commercial channel, but also an indirect one because of deteriorating confidence, which could hold back private consumption and, above all, investment.

The asymmetry of the Bank of England's reaction function suggests that the expected hike in interest rates could be delayed until the third quarter of 2015

In the last three months, greater moderation in inflation than anticipated in the August IR and the increased uncertainty about certain global factors (the eurozone and oil prices) have given rise to a much more cautious tone on the part of the Bank of England's Monetary Policy Committee (MPC). This has been reflected in both the November IR and in the minutes, as well as in many of the statements by MPC members in recent months, stressing the asymmetric nature of the monetary policy reaction function, insofar as it emphasises the greater risks of a premature interest rate hike (risks for activity and with very low inflation which could slip below 1% YoY) than those implicit in a later and less gradual increase. Nevertheless, the November minutes still show that since August there have been seven votes in favour of continuing with the current monetary policy stance, against two members who have proposed an immediate rise in rates. As to the opinion of these two members, recent employment market data (unemployment and wages) give more force to their arguments, but the low rate of inflation and the increased risks coming from abroad continue to persuade the other seven. However, among this latter group, the main issue now is the greater discrepancy between their assessments of medium-term inflation and, as a result, greater reliance on the new data as they are published in the next few months (wages and inflation), which will determine their vote (in line with the second phase of forward guidance).

Even though our economic scenario is virtually unchanged from three months ago, we now expect the first interest rate hike by the Bank of England to be delayed and to take place in the third quarter of next year (as against the increase coming in the first quarter as we forecast three months ago), motivated not only by the deterioration in certain external factors, but also by the increased uncertainty about some of the internal factors. In particular, May next year will see the general election and the strength of the new government's commitment to consolidating public accounts will be critical, especially in view of the fact that there are doubts as to whether the fiscal targets will be met this year. A restrictive fiscal policy, taken with the cooling of the property market and confidence on the part of the economic agents, increases the uncertainty about the sustainability of strong domestic demand, above all when the deterioration of global factors is likely to delay the return to a more balanced pattern of growth.

Table 1
BBVA Research GDP and inflation growth forecasts (November 2014)

YoY rate	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-0.5	-3.1	0.4	0.1	1.1	1.6	2.2	2.3
Public consumption	2.2	1.0	0.0	0.0	2.3	0.7	1.0	0.1
Gross fixed capital formation	-4.7	-14.4	5.9	2.3	0.7	3.2	8.0	6.3
Inventories (*)	-0.5	-0.6	1.5	-0.2	0.1	0.1	0.1	0.0
Domestic demand (*)	**-1.4**	**-5.0**	**2.8**	**0.3**	**1.5**	**1.7**	**3.0**	**2.6**
Exports	1.6	-8.2	6.2	5.6	0.7	0.5	-1.1	3.5
Imports	-1.8	-9.8	8.7	1.0	3.1	0.5	-1.2	3.0
Net exports (*)	**1.1**	**0.7**	**-0.9**	**1.4**	**-0.8**	**0.0**	**0.0**	**0.1**
GDP	**-0.3**	**-4.3**	**1.9**	**1.6**	**0.7**	**1.7**	**3.0**	**2.7**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.6**	**1.5**	**1.6**

(*)Contributions to growth.
Source: BBVA Research

United Kingdom

National accounts: solid growth in 3Q14, but easing a little

GDP grew by 0.7% QoQ in 3Q14, supported by the services sector and, to a lesser extent, by industry. Data available point to strong domestic private spending, while support from the foreign sector is waning. For 4Q14, growth may moderate somewhat.

Figure 1
GDP (% QoQ) and contribution by component (pp)*

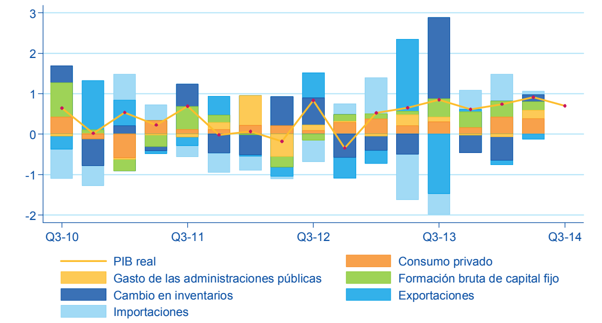
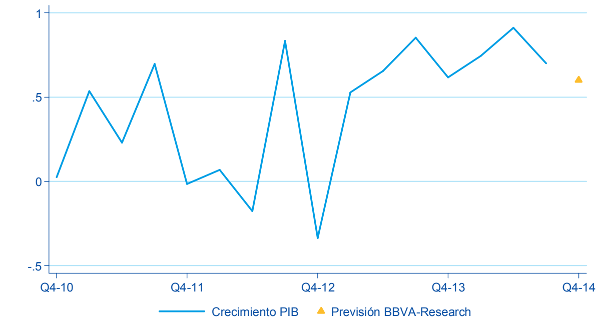


Figure 2
GDP growth (% QoQ) and preliminary estimate



Confidence: high levels, after the moderation at the beginning of the year

Confidence remains at high levels (above the historical average), which ought to help economic agents to make decisions, particularly in investment, in order to sustain a relatively stable growth over the next few quarters.

Figure 3
PMI and GDP growth (% QoQ)*

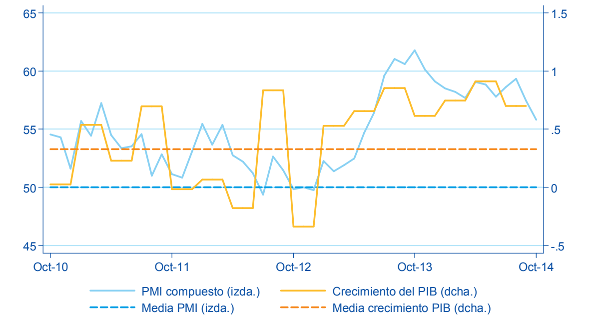
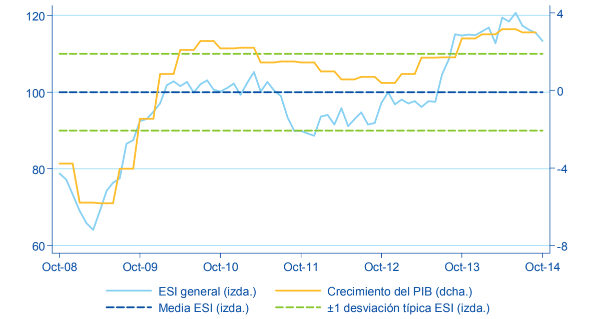


Figure 4
Confidence (ESI) and GDP growth (% YoY) **



Activity: investment and consumption move forward at a steady pace

Industrial production progressed in 3Q14 at a slightly slower rate. Despite a slowdown in retail sales, these point to solid growth in private consumption in the second half of the year.

Figure 5
Industrial prod. (% YoY) and manufacturing PMI*

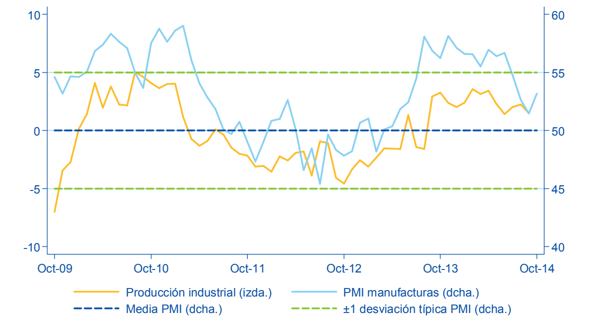
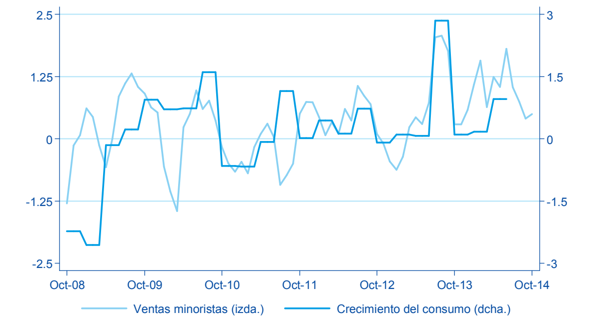


Figure 6
Retail trade (% 3m/3m) and consumption growth (% QoQ)*



*Source: Haver Analytics and BBVA Research

Foreign sector: doubts remain about the greater role of exports

Balance of trade figures suggest that the contribution of net exports will have continued to soften (around -0.1pp in 3Q14, down from 0.6pp in 1Q14 and 0pp in 2Q14).

Figure 7
Trade balance (% of GDP)*

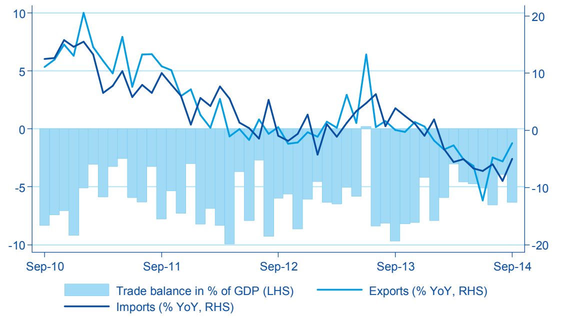
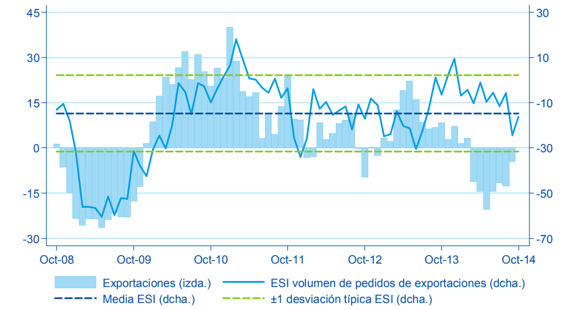


Figure 8
Export growth (% YoY) and volume of export order books*



Labour market: sturdy job creation, with timid wage rises

The unemployment rate continued to fall to 6.0% in the three months to September. Increases in the number of waged employees and full-time jobs may be behind the recent rise in wages (1.3% 3m/3m in September after having failed to break the 1% barrier in the last two quarters).

Figure 9
Unemployment rate (%) and employment expectations*

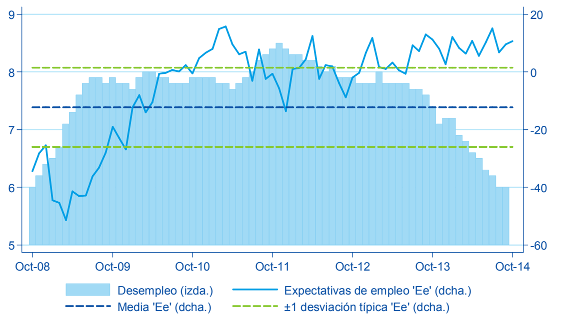
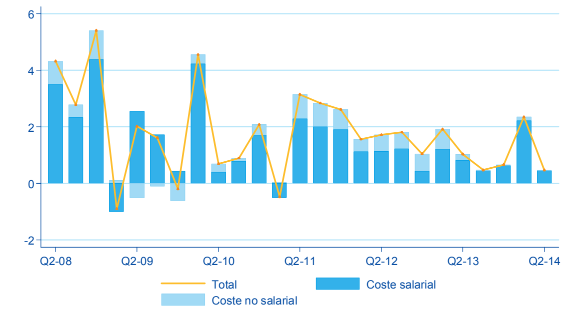


Figure 10
Labour cost in the business sector (% YoY)*



Prices: inflation will continue to hover around 1.2% in the coming months

Moderation in inflation in 3Q14, because of the behaviour of food and energy prices. The strength of sterling, the lower commodity prices and the moderate wage inflation underpin our scenario, which has risks to the downside.

Figure 11
Inflation rate, headline and core (% YoY)*

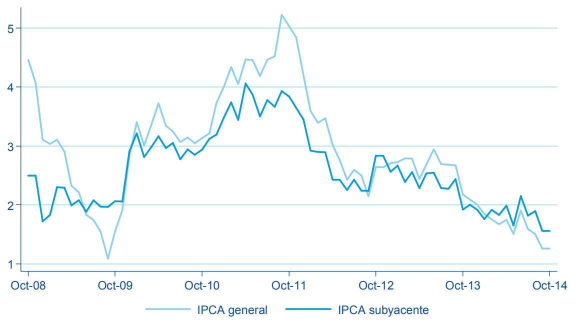
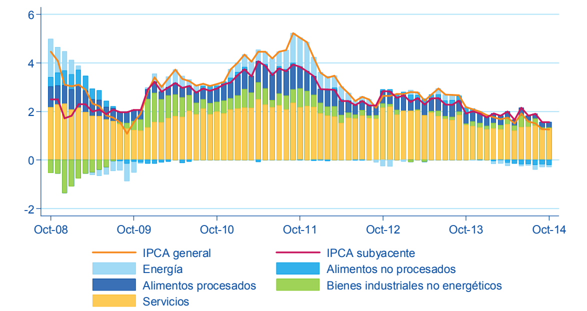


Figure 12
Inflation by components (contribution in %)*



* Sources: Haver Analytics and BBVA Research

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