MACROECONOMIC ANALYSIS

United Kingdom: the strength of internal factors and oil will favour higher growth in 2015

Europe Unit

Over the last three months, domestic factors underlying the economy's performance have behaved as expected (more employment, improvement in confidence and borrowing conditions, commitment to an accommodative monetary policy) and have been reinforced by certain external factors, in particular the sharp fall in the oil price, whereas the greater momentum in European economies should provide increased support for net exports than was forecast three months ago. Against this backdrop, the strong growth, the increase in wages and the dispersal of the baseline effect of the fall in oil price on inflation in 2H15 will open the way for a very gradual normalisation of monetary policy from the final quarter onwards, although high levels of uncertainty, especially political, could result in holding back domestic demand and influencing the Bank of England's decisions.

Growth moderated in 4Q14, although it remained robust, with GDP expansion of 2.6% in 2014 supported by the strength of private consumption and the uptick in investment

Although the moderation in GDP growth in 4Q14 (0.5% QoQ, down from 0.7% QoQ in 3Q14) was a little greater than expected (BBVA Research: 0.6%), the biggest surprise was in its composition. On the negative side of the balance, investment fell by -0.5% QoQ, although not across the board (in transport and other constructions it was -7.1% QoQ and -3.1% QoQ, respectively), but private consumption moderated more than we had forecast. On the positive side, there was a strong jump in exports, together with the moderation in imports because of the lower momentum in domestic spending, resulting in a significant positive contribution on the part of net exports of 0.6pp.

Nevertheless, the composition on the supply side (with the services sector making up 0.6pp of quarterly GDP growth) and the most recent figures (strong retail sales and an increase in consumer and capital goods production, together with a generalised improvement in confidence among consumers and companies), indicate that the pattern of growth in the next few quarters will continue to be mainly based on the strength of domestic demand (Figures 1 to 6), although the greater momentum of European economies could boost external sales somewhat more than it has done so far in the central quarters of 2014 (Figures 7 and 8). This is the trend we saw over 2014 as a whole, in which the 2.6% growth in GDP was based on private consumption (2%) and the jump in investment (6.8%, up from 3.4% in 2013), with a 3.1pp contribution from domestic demand; however, weak exports (0.4%) and greater dynamism in imports (1.8pp) meant that net exports drained 0.5pp from annual GDP growth.

The improvement in the job market will continue this year and next, although with a slower job creation rate and higher nominal wages…

In the second half of 2014, jobs continued to grow (0.4% QoQ), although at a rather more moderate rate than in previous quarters (at around 0.8% QoQ) and, furthermore, the improvement was again down to full-time wage-employment, against the increase in self-employed and part-time occupations in previous quarters. These changes in the labour market resulted in a relatively smooth increase in productivity (around 0.3% QoQ on average since 2Q14) which, together with the change in the composition of employment creation, has meant an increase in nominal wages (of as much as 2.2% YoY in 4Q14, pushed upwards by the private sector and partly offset by a much more moderate growth in public sector jobs).

Over our forecast horizon, the confidence surveys suggest that wages could continue to rise, in line with the projections of February's *Inflation Report*, which estimates that wages will grow by 3.5% in 2015 and will accelerate to 4% in 2016, showing similar increases to those of before the crisis. Given the uncertainty about the measurement of the economy's slack capacity (which the BoE now puts at 0.5% of GDP and which it believes will diminish over the forecast horizon) and on the possible indirect and second round effects of the drop in energy prices for most of the year, the movement of wages has become a key variable for establishing monetary policy for the next few months.

This hike in wages should occur with a somewhat more moderate growth in employment (around 1% during our forecast horizon, down from 2.3% in 2014), given that behind the hearty GDP growth there ought to be a productivity uptick, while the unemployment rate will taper towards the equilibrium rate (around 5%). The moderate increase in wages over 2014 as a whole (1.2%), together with the rise in productivity (0.7%), is reflected in a slowdown of unit labour cost rises (0.3% to 3Q14), which will remain moderate for the next few years despite the wage rise (at around 2.5%, compared to increases of around 4% before the crisis), which could favour the competitiveness of companies and allow growth to be more balanced.

… and real wages, due to the sharp reduction in inflation caused by the fall in the oil price this year

The slowdown in inflation intensified in the last quarter of 2014, shrinking by nearly 1pp to 0.3% YoY in January (Figures 11 and 12), while core inflation remained stable, at 1.2% YoY, at the beginning of the year for the third month in a row, after the moderation in September (around 1.8% during the first three quarters). The reasons behind this reduction in inflation continue to be lower food prices, but above all the intensification in the fall of energy product prices because of the change in the cost of oil, plus the appreciation of sterling. This was the main explanation given in the letter from the Governor of the Bank of England, Mark Carney, to the Chancellor of the Exchequer to explain why inflation is under 1%, since he estimated that two-thirds of inflation's current deviation from the 2% target is down to the fall in energy and food prices, and the remainder to weak domestic demand and the absence of pressure (through wages) during the crisis.

Our forecasts suggest that inflation could continue to fall in the first quarter, staying relatively stable at very low rates in the second quarter and picking up more noticeably in the second half of the year. In consequence, annual average inflation could post at 0.4% in 2015 and at 1.5% in 2016.

Domestic demand will continue to be the main bulwark for the strong growth expected for 2015-16, while net exports will again contribute slightly to this progress

Greater growth in private consumption, together with a robust investment rate, underpinned by a gradual rise in foreign sales will be the main determinants behind this solid GDP growth, around 0.6% QoQ on average over the forecast horizon that results on an economic growth of 2.8% in 2015 and of 2.6% in 2016.

Expectations of low interest rates for a long period, the reduction in energy costs plus better access to funding for companies will all continue to make investment buoyant (around 5% in 2015 and 6% in 2016), especially since its used capacity is already above its historical average. On the other hand, job creation and the improvement in real wages will impact on an increase in households' disposable income, which will thus not need to continue to reduce their savings rate to maintain consumption; this will enable them to continue the process of reducing debt which was interrupted at the end of 2013 when household debt stabilised at around 138% of disposable income (from its peak of nearly 170% in 2008). All this will be reflected in an increase in private consumption of over 2% in 2015 and 2016, although still below the pre-crisis growth rate, because of the need to continue deleveraging.

This year the fiscal consolidation process will be addressed again, with all the attendant uncertainty around the general election, for which reason we expect a significant moderation in public consumption in 2015 and a cut in 2016.

Finally, net exports will return to making a small contribution to growth, with a contribution of 0.2pp and 0.1pp in 2015 and 2016 respectively.

The risks to this scenario continue biased to the downside and come mainly from the impact of political uncertainty about the May general election, among other reasons because of the implications that it might have on the rate and composition of the fiscal correction, as well as on the debate about the referendum on whether to stay in the European Union. All this could have a negative effect on economic agents' confidence and weaken domestic demand, particularly investment, together with a possible cooling of the real estate market. Turning to external issues, uncertainty about geopolitical tensions, which could end up affecting foreign demand, continues.

In this scenario, we expect the BoE to begin a very gradual normalisation of monetary policy in 4Q15

The sharp reduction in inflation in the last few months as a result of the oil shock, together with an increase in uncertainty in other areas (particularly in Europe because of the issue of Greece) was reflected in a much more accommodating stance on the part of the BoE's Monetary Policy Committee (MPC) as of November, and ended with a unanimous vote to keep the interest rate unchanged at January's meeting (with the withdrawal of the votes of McCafferty and Weale in favour of raising it), since the risks of an early hike rise weighed more than those of a later and less gradual normalisation, because the concerns about inflation have not been dispelled in the short term. Among these is the possibility of low inflation becoming entrenched, with the indirect and second round effects of the fall in energy prices feeding into this, in a context of lower demand which might put an end to the anchoring of medium- and long-term inflation expectations.

Nevertheless, unlike the reports published in November, the *Inflation Report* and the February minutes show a much more optimistic stance from the BoE. Governor Carney pointed out that the impact of the oil shock is clearly positive, inasmuch as it responds mainly to supply factors, and that it will be another support factor sustaining growth, whereas, despite the permanent effect on prices, it will have a transitory impact on the inflation rate, which will start to disappear in the second half of 2015. That the BoE sees this scenario as being much more probable is demonstrated by the fact that the governor spent more time on explaining the risks to the upside in the medium and long term, even pointing out that the impact of monetary policy measures tends to lag by between 18 and 24 months, implying that market expectations that the first interest rate hike will take place well into 2016 could be wide of the mark.

In terms of the risks, the BoE considers that at the moment they are balanced. The risks to the upside would come from a swifter absorption than expected of the economy's slack capacity, of a higher growth in wages and/or an uptick in oil prices. The risks to the downside continue to be associated with political uncertainty, both domestic (elections in May and the debate about the referendum on whether to stay in the EU) and external (Greece and geopolitical tensions); plus the risk that slack capacity might be higher than expected, together with the possible second-round effects of low energy prices. If these risks to the downside materialise, Carney indicated that the MPC might extend QE; here the main piece of news was the fact that he broke the taboo of taking interest rates under 0.5% if necessary, since now the financial system is healthier and the negative effects of lower interest rates are reduced. As to the doubts created by these declarations, he used the press conference to emphasise that the most likely next movement will be an interest rate hike.

In view of our economic scenario and the latest declarations by the MPC, we have put back our forecast for the beginning of a very gradual normalisation of monetary policy until the final quarter of this year, a change from our expectations three months ago that the first interest rate rise would be one quarter earlier, particularly because we think that the members of the MPC will wait and see whether the forecast of a jump in inflation and wage growth materialises before starting the rises.

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

YoY rate	2009	2010	2011	2012	2013	2014	2015	2016
Private consumption	-3.1	0.4	0.1	1.1	1.7	2.0	2.6	2.2
Public consumption	1.0	0.0	0.0	2.3	-0.3	1.5	0.5	-0.4
Gross fixed capital formation	-14,4	5,9	2.3	0.7	3.4	6.8	5,2	5,8
Inventories (*)	-0.6	1.5	-0.2	0.1	0.2	0.3	0.0	0.0
Domestic demand (*)	**-5,0**	**2.8**	**0.3**	**1.5**	**1.7**	**3.1**	**2.6**	**2.4**
Exports	-8,2	6.2	5,6	0.7	1.5	0.4	3.5	5,2
Imports	-9,8	8,7	1.0	3.1	1.4	1.8	2.7	4,4
Net exports (*)	**0.7**	**-0.9**	**1.4**	**-0.8**	**0.0**	**-0.5**	**0.2**	**0.1**
GDP	**-4,3**	**1.9**	**1.6**	**0.7**	**1.7**	**2.6**	**2.8**	**2.5**
Inflation	**2.2**	**3.3**	**4,5**	**2.8**	**2.6**	**1.5**	**0.4**	**1.5**

(*)Contributions to growth.
Source: BBVA Research

United Kingdom

National accounts: solid growth in 4Q14, but somewhat more moderate

GDP grew by 0.5% QoQ in 4Q14, buoyed by the uptick in exports. Over the year as a whole, GDP grew 2.6%, driven by robust private demand and the push upwards from investments. For 1Q15, we expect growth of around 0.6% QoQ.

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

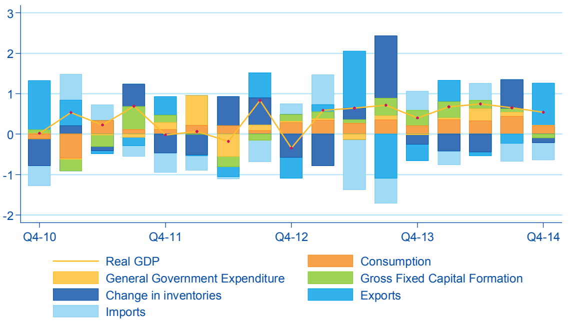
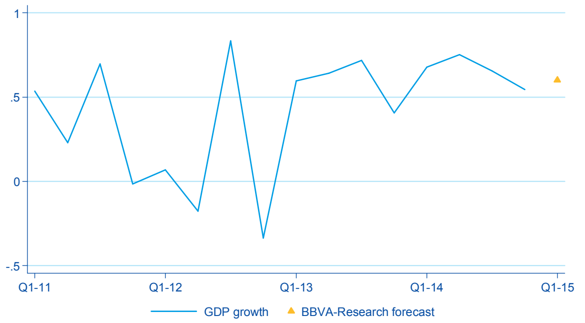


Figure 2
GDP growth (% QoQ) and preliminary estimate



Confidence: stable at high levels, after the moderation last year

Confidence remains at high levels (above the historical average), which ought to have the outcome of materialising the decisions by economic agents, particularly in the area of investment, in order to sustain relatively stable growth over the next few quarters.

Figure 3
PMI and GDP growth (% QoQ)*

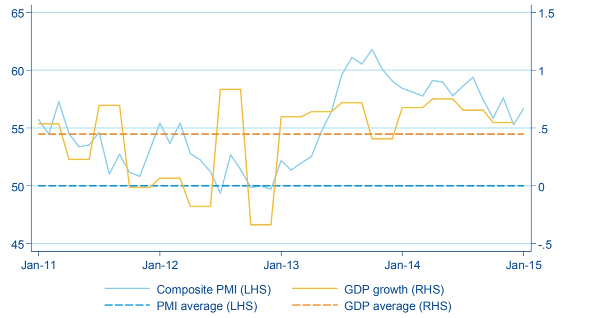
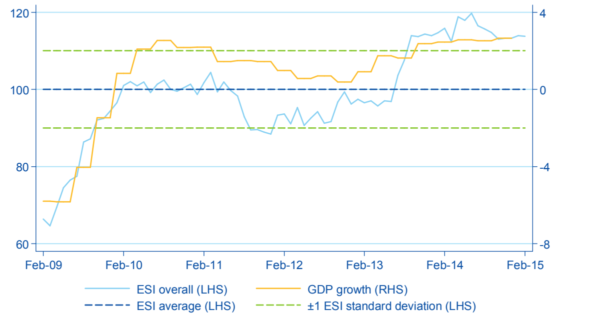


Figure 4
Confidence (ESI) and GDP growth (% YoY) **



Activity: investment and consumption both make solid progress

Industrial production of capital goods and consumer durables progressed at a good rate in 4Q14. Despite the moderation in retail sales at the beginning of the year, the jump in 4Q14 suggests that the solid growth of private consumption is continuing.

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

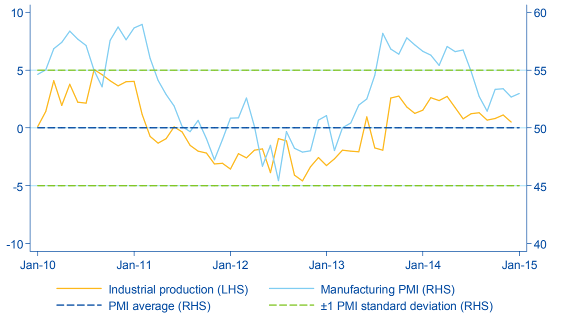
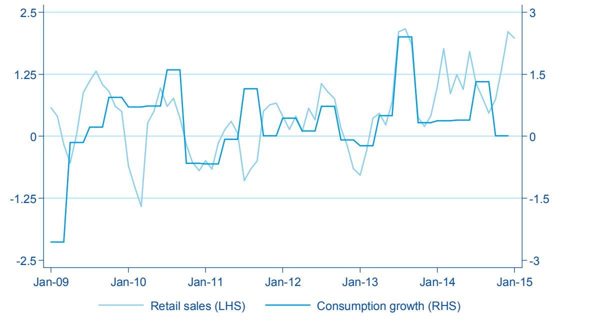


Figure 6
Retail trade (% 3m/3m) and consumption growth (% QoQ)*



*Source: Haver Analytics and BBVA Research

Foreign sector: exports improved in 4Q14, after a disappointing few quarters

The improvement in exports in 4Q14 was a response to the uptick in external sales in September, but the November and December figures were not so strong and uncertainty persists about whether their recovery is sustainable.

Figure 7
Trade balance (% of GDP)*

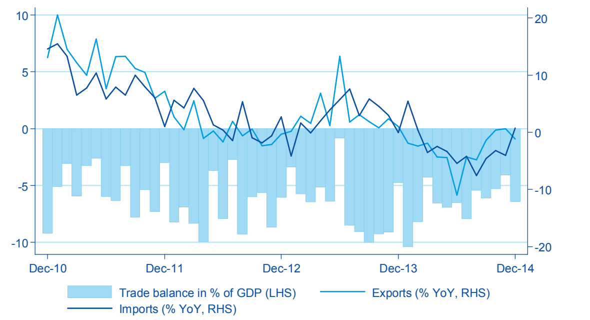
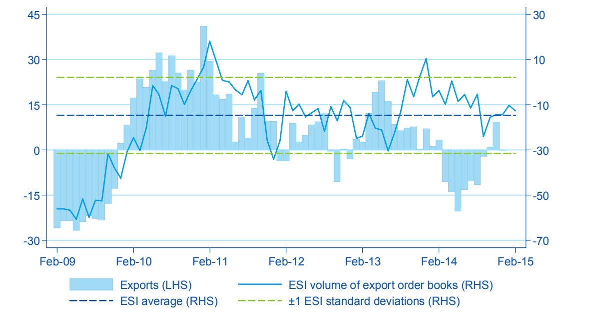


Figure 8
Export growth (% YoY) and volume of export order books*



Labour market: job creation moderates and wages rise

The unemployment rate continued to fall to 5.7% in the three months to November. An increase in full-time wage employment may have been behind the recent increase in wages (2.2% 3M/Y in December).

Figure 9
Unemployment rate (%) and employment expectations*

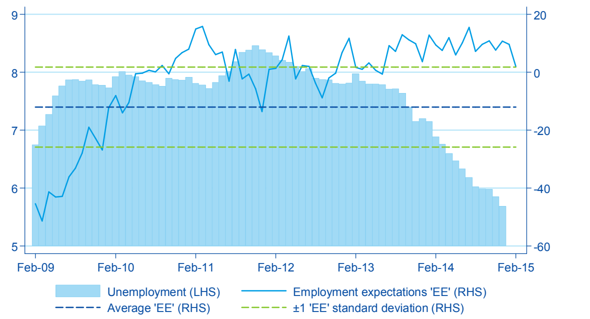
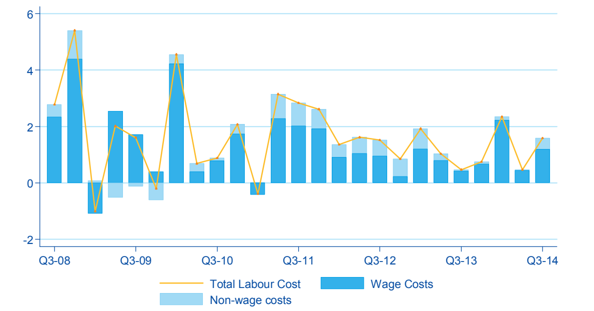


Figure 10
Labour cost in the business sector (% YoY)*



Prices: inflation below 0.5% in 2015 before rising to 1.5% in 2016

The sharp moderation in inflation continued in 4Q14, coming in at 0.3% YoY in January because of the change in food prices and energy in particular. Furthermore, this moderation will continue over the coming months and begin to climb back in the second half of the year.

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

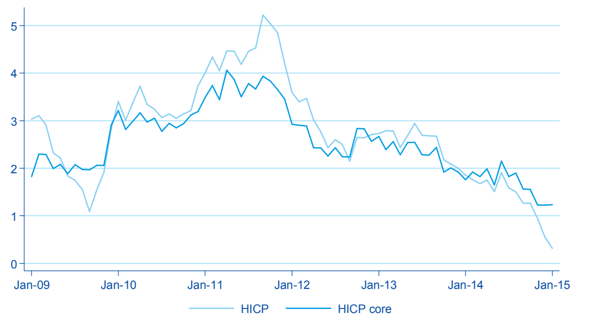
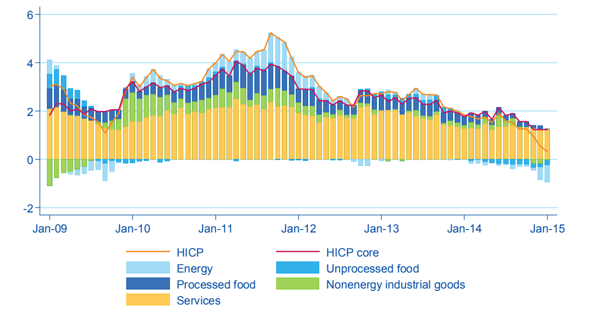


Figure 12
Inflation by components (contribution in %)*



* Source: Haver Analytics and BBVA Research

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