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Eurozone Economic Watch

Higher growth and more subdued inflation in 2017-18

October 2017

Eurozone: Higher growth due to strong domestic demand, but more subdued inflation

- Our **MICA-BBVA model** for short-term growth estimates a quarterly **GDP figure of around 0.6% in 3Q17**, after the slight upward revision to 2Q17 growth to 0,7% QoQ.
- **Confidence moderated slightly in October, and seems to be stabilizing**. The service sector lost all the ground recovered in September offsetting the improvement in manufacturing.
- **Activity data improved in August**, after disappointing figures in July, **suggesting that the recovery in the industrial sector and exports remains on track** supported by both strong domestic and global demand, while the impact of the euro seems to be limited so far. **Retail sales softened again in August,** suggesting some moderation in consumption, but **employment gains and the positive consumer mood** will continue to support it.
- We **revise upwards GDP growth forecast** on account of stronger data and strengthening domestic drivers **to 2.2% in 2017 and 1.8% in 2018** amid high political uncertainty.
- **Headline inflation is expected to decline by year end** driven by the negative base effect of energy prices along with the appreciation of the euro, **while core inflation is likely to remain fairly stable until the end of the year,** after increasing by 0.5pp since end-2016, **keeping a very gradual upward trend onwards.**
- We revise **slightly down our headline inflation forecasts** to 1.5% in 2017 and 1.2% in 2018, **but maintain our projections for core inflation** (1.1% and 1.4%, respectively).

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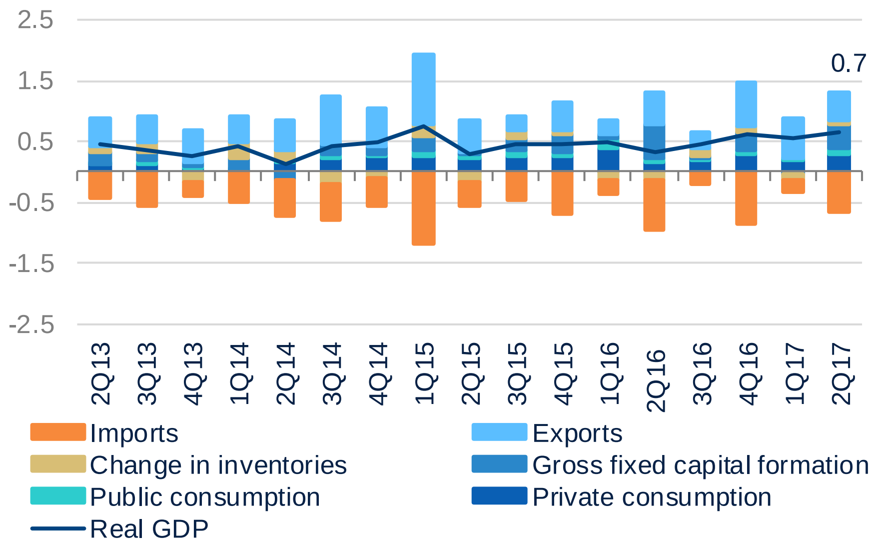
Economic developments:

Robust growth and subdued inflation in 2S17

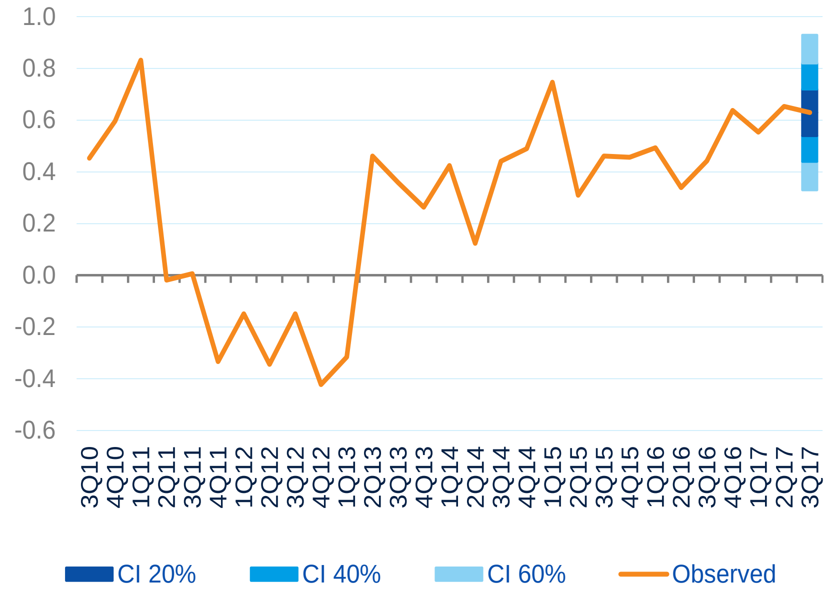
October 2017

Incoming data suggest a robust and fairly steady GDP growth in 3Q17

GDP, Contribution by Components
(%QoQ, pp)



GDP and MICA forecasts
(%QoQ)

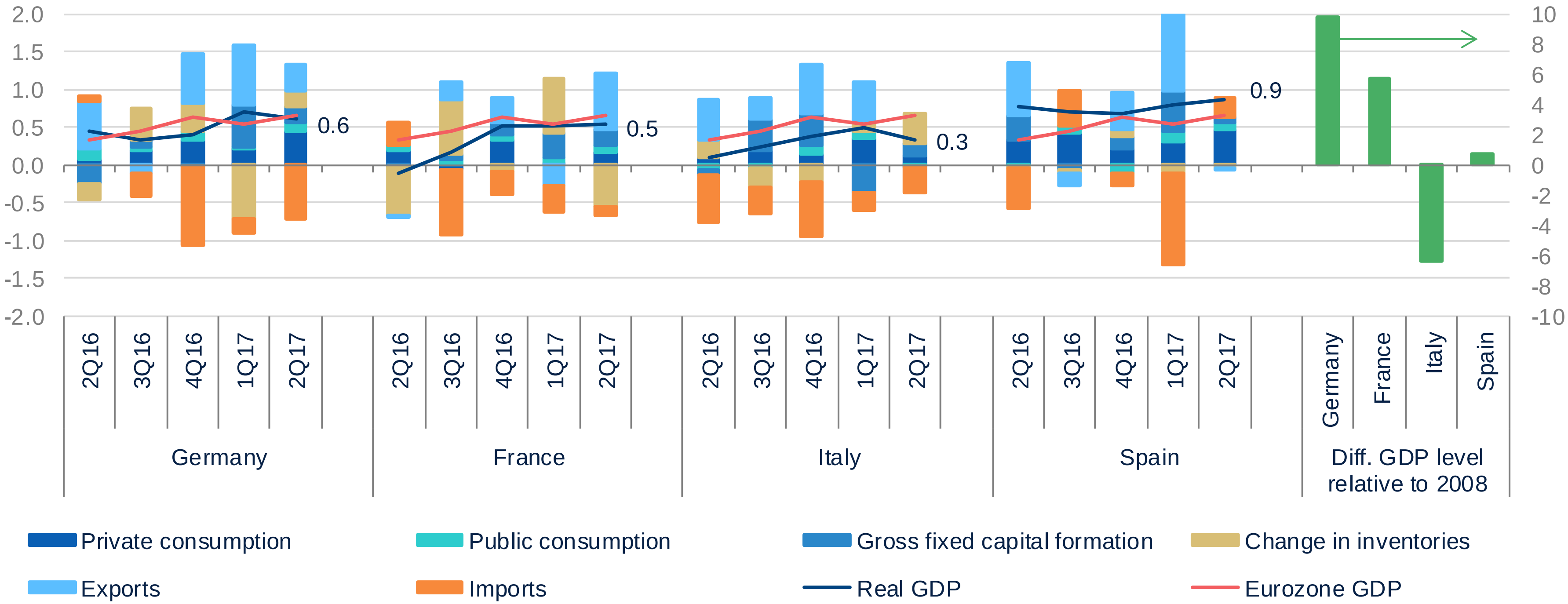


Source: Eurostat and BBVA Research

- GDP **growth accelerated to 0.7%** QoQ in 2Q17. **Domestic demand** is behind the recovery, strengthening on the back of **investment**
- As a consequence, imports accelerated more than exports, leading to a **negative contribution to growth from external demand**
- Our **MICA-BBVA** model suggests a stabilization of **GDP growth at 0.6% in 3Q17,** but we cannot discard some further moderation

France and Italy GDP growth remained stable at decent levels in 2Q17, while Germany registered a slight deceleration to 0.6%

GDP, Contribution by components
(%QoQ, pp)



Source: Eurostat and BBVA Research

- In **France, GDP grew 0.5% QoQ in 2Q17** driven by a strong net exports' contribution
- In contrast, **domestic demand** was the main contributor **in Germany** (driven by consumption) **and Italy** (due to investment)
- **Spain's growth continues to outperform** the region, at 0.9% QoQ, though it is **decelerating**

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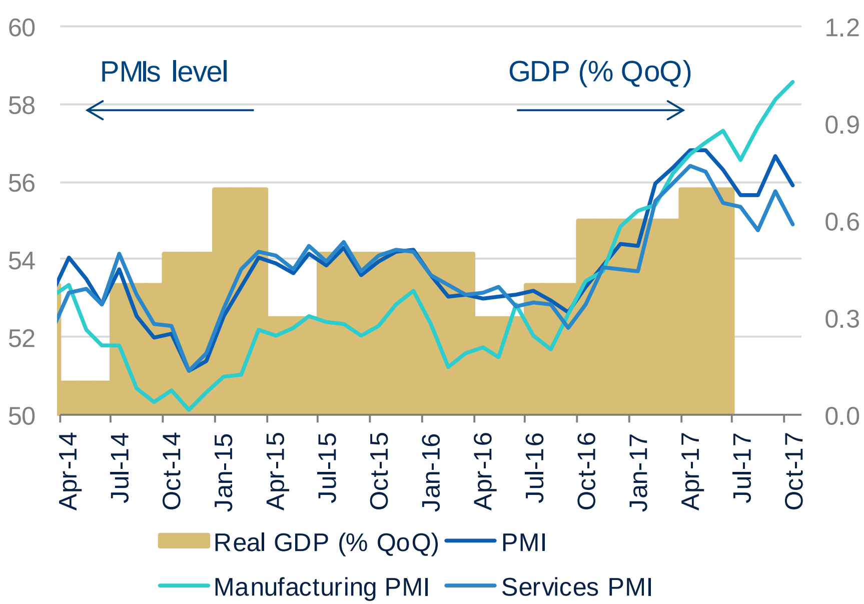
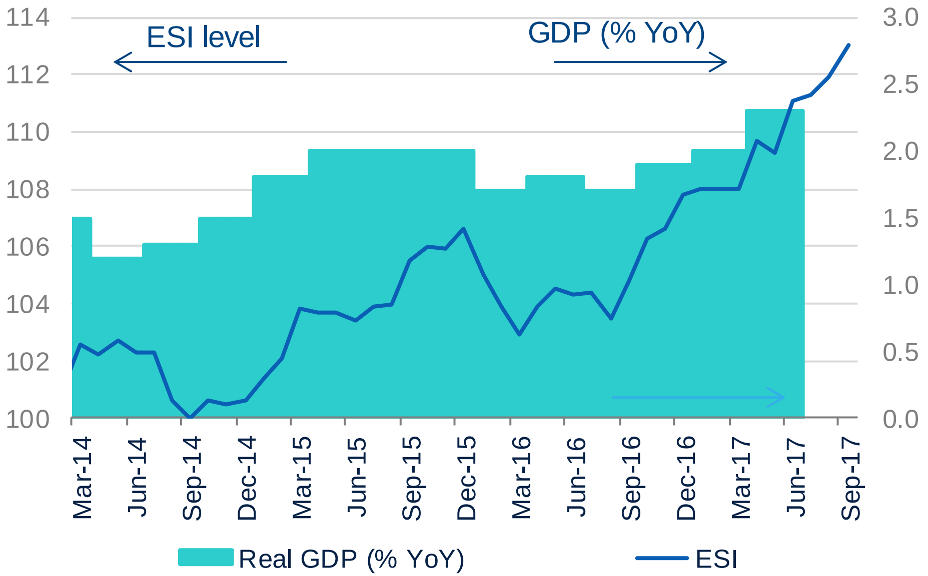
Confidence figures moderated slightly in October due to less optimism in services

PMI and GDP
(level, %QoQ)



ESI and GDP
(level, %YoY)

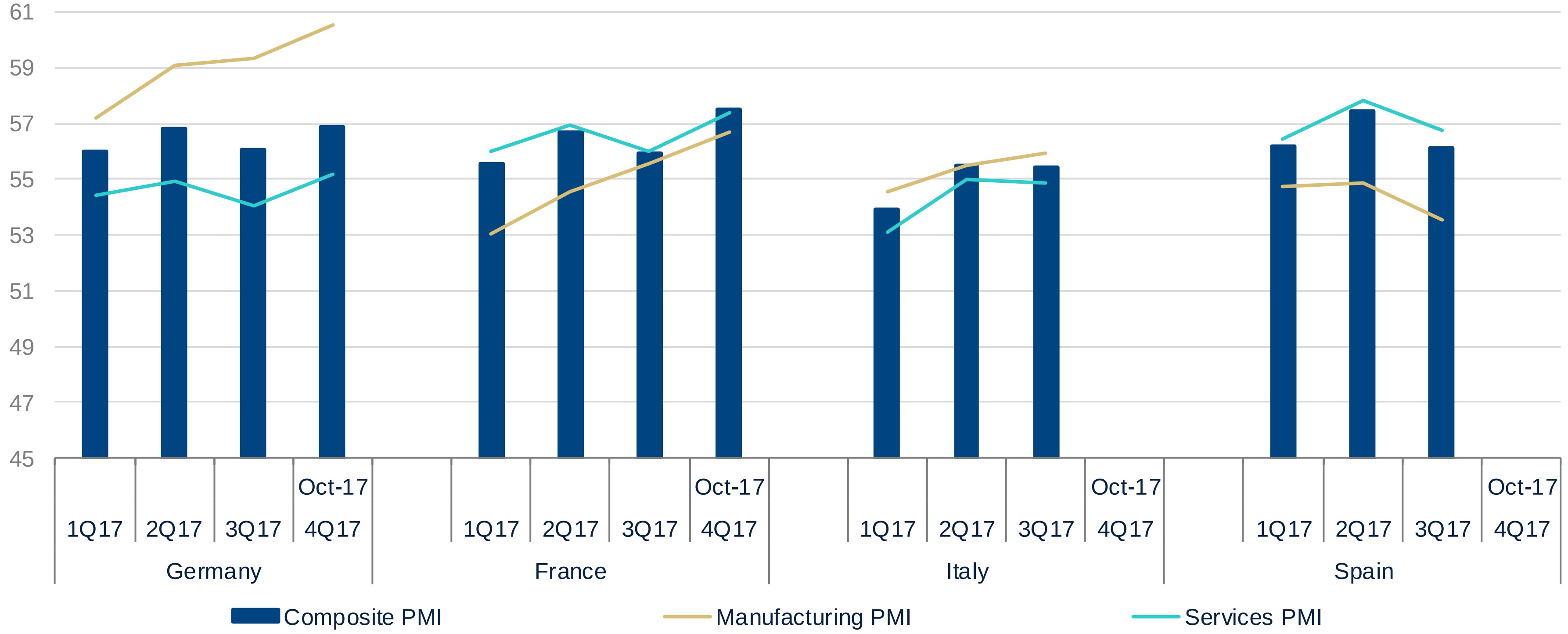


Source: Eurostat and BBVA Research

- **In October, confidence levels declined in services** while they **increased again in manufacturing** on the back of stronger new orders, according to PMIs
- **Confidence among both businesses and consumers has risen to its highest level** since before crisis, according to the European Economic Sentiment (ESI)

PMI: France surprised to the upside in October while Germany came below expectations, but still present clear gains over the last quarter

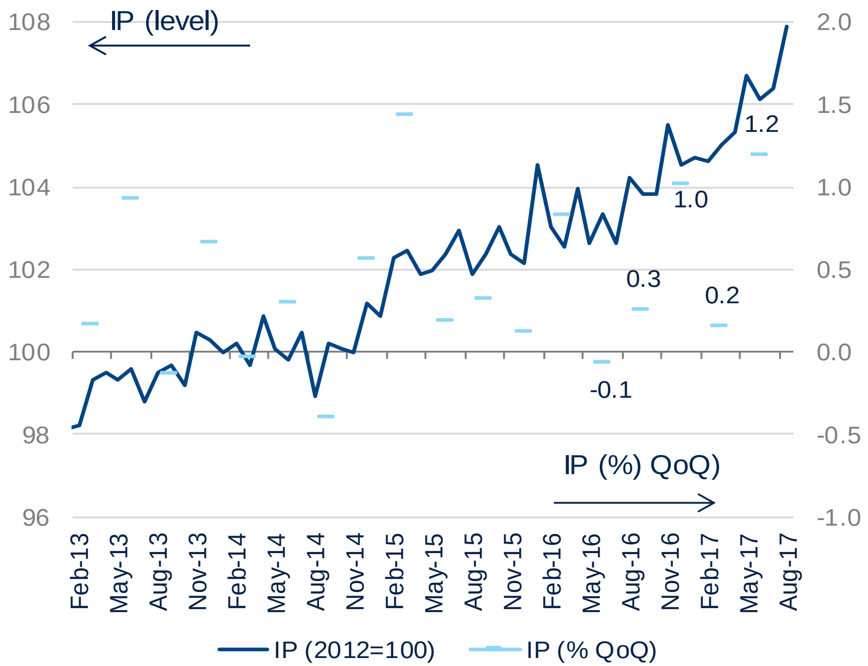
PMI
(level)



Source: Eurostat and BBVA Research

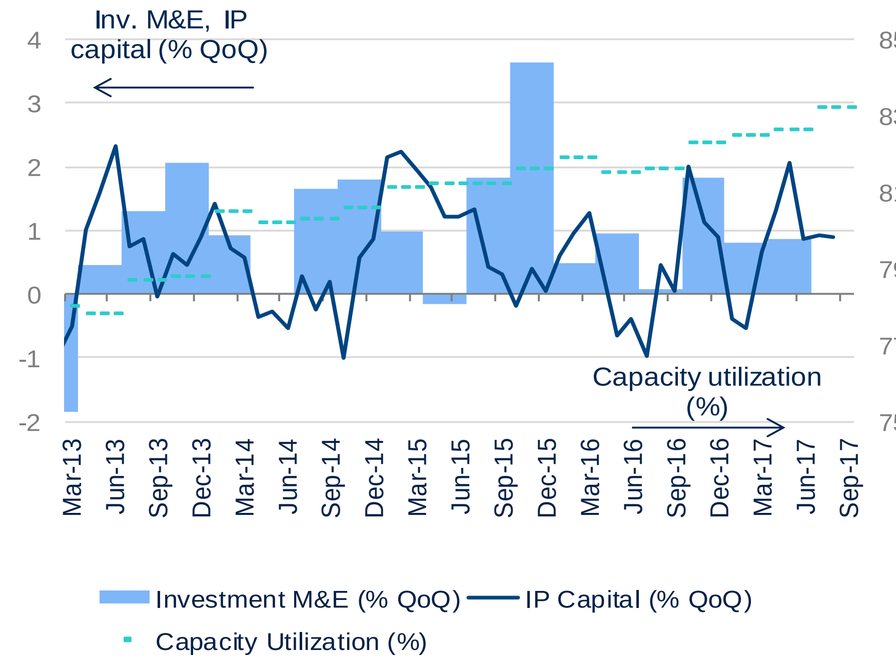
Industrial production surged in August, more in line with signs from confidence surveys, and suggests that the recovery is on track

Industrial production
(level, %QoQ)



Source: Eurostat and BBVA Research

IP capital, investment in machinery and equipment and utilization capacity
(%QoQ, %)

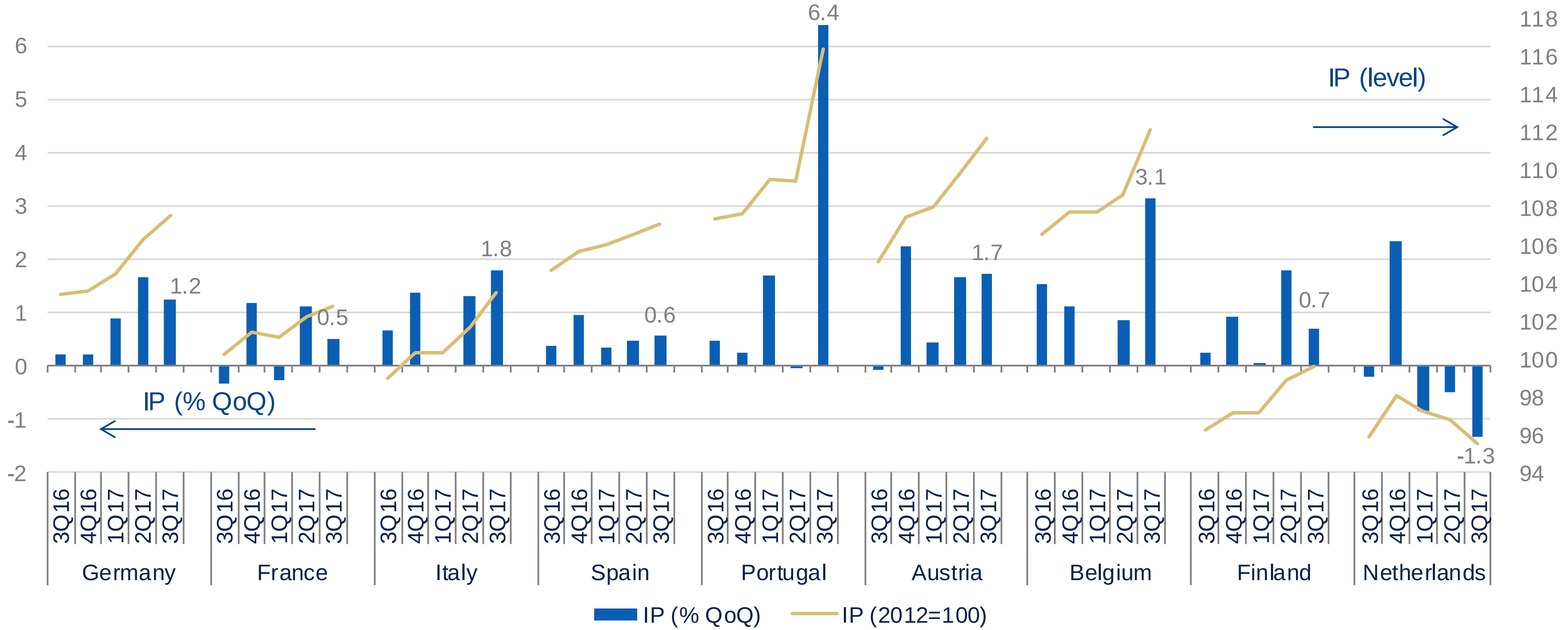


Source: Eurostat and BBVA Research

- **Industrial production improved strongly (+1.4% MoM)** after a disappointing figure in July
- **The increase in production of durables and capital goods, together with high capacity utilization,** point to a still favourable outlook in coming months

Industrial output growth was observed in the majority of countries during 3Q17

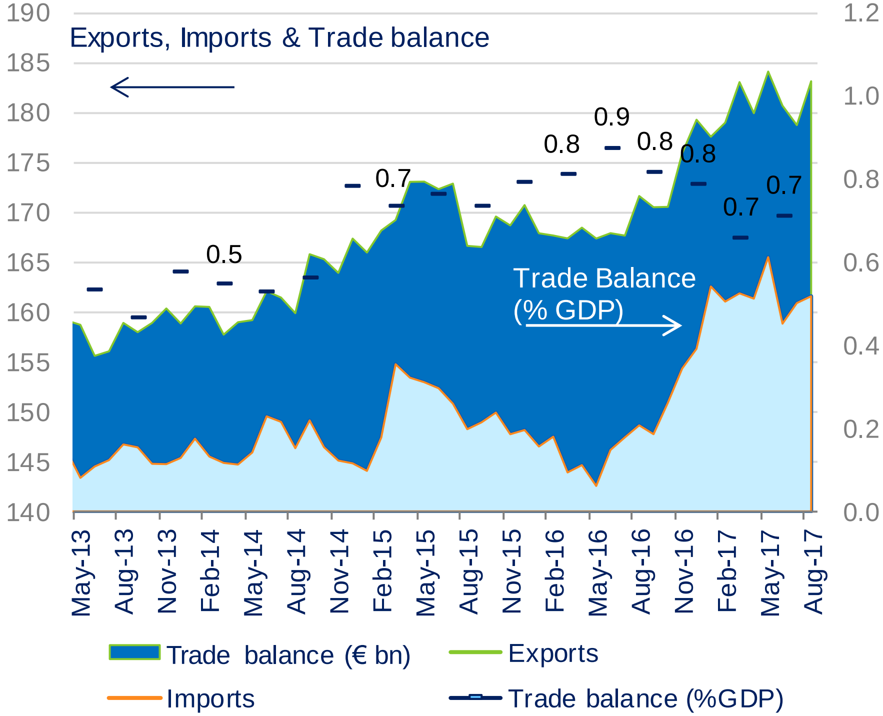
Industrial production
(%QoQ, level)



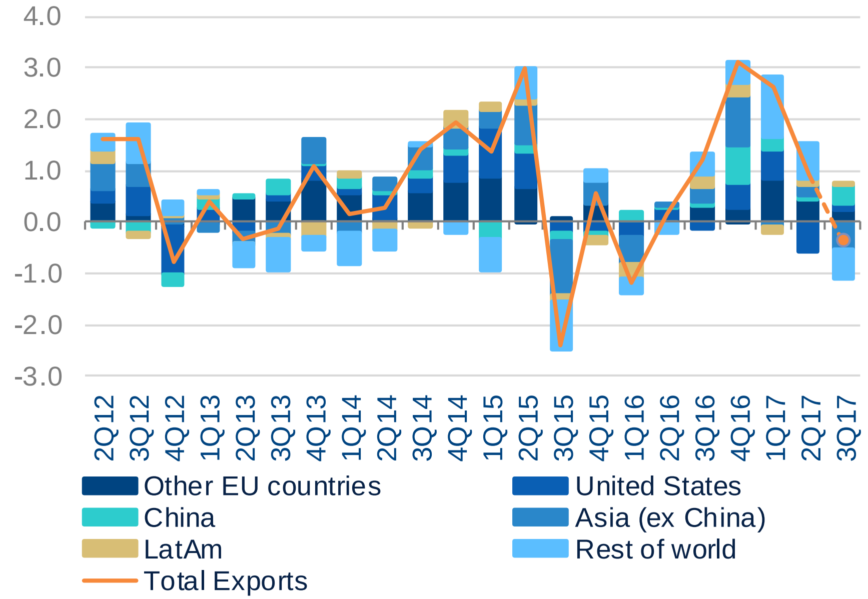
Source: Eurostat and BBVA Research

Foreign trade figures improved in August but still suggest some moderation for 3Q17

Trade balance
(€ bn, %GDP)



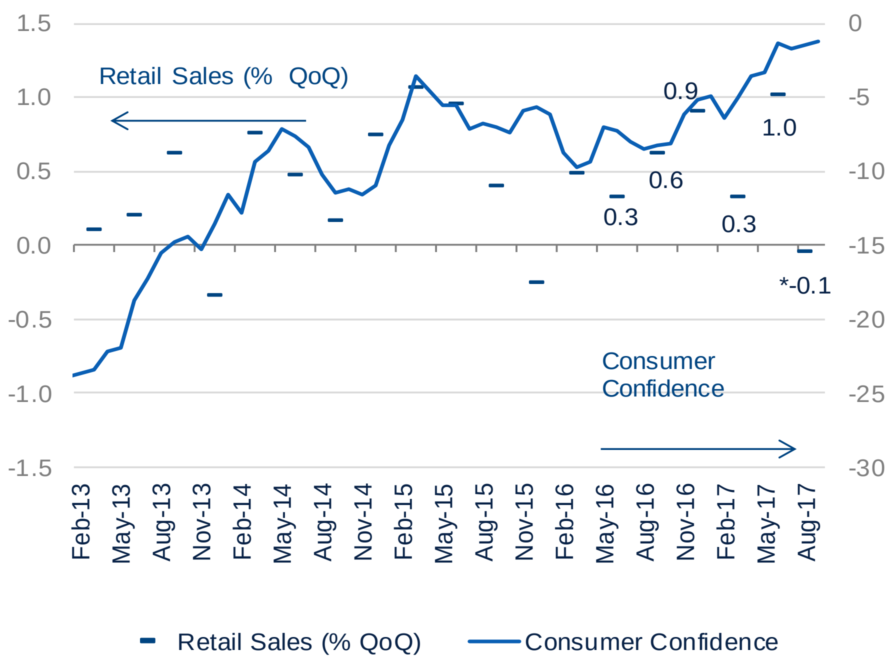
Exports contribution by destination
(%QoQ, pp)



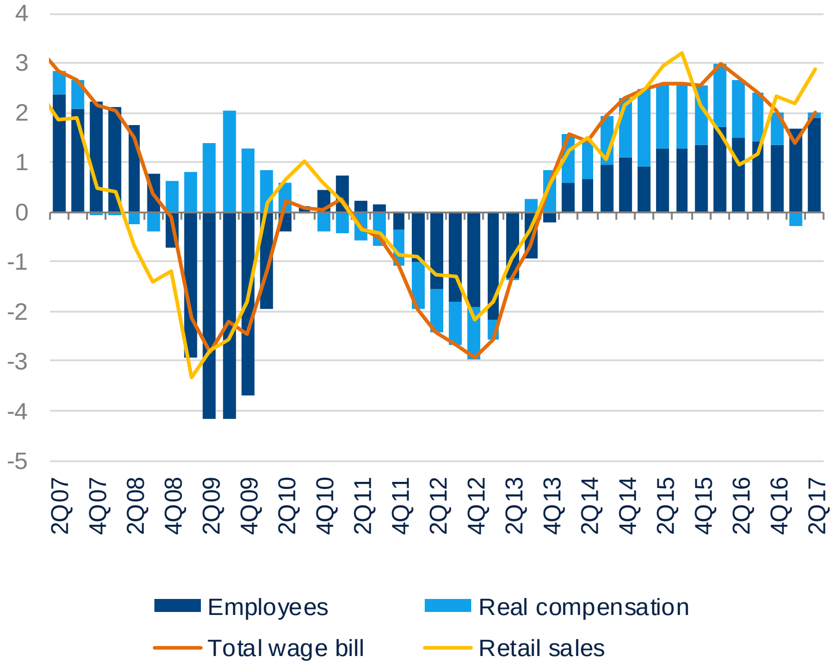
Source: Eurostat and BBVA Research

Retail sales continue to moderate in 3Q17 while consumer confidence remained stable

Retail sales and consumer confidence
(%QoQ, pts)



Retail sales and total wage bill
(%YoY)

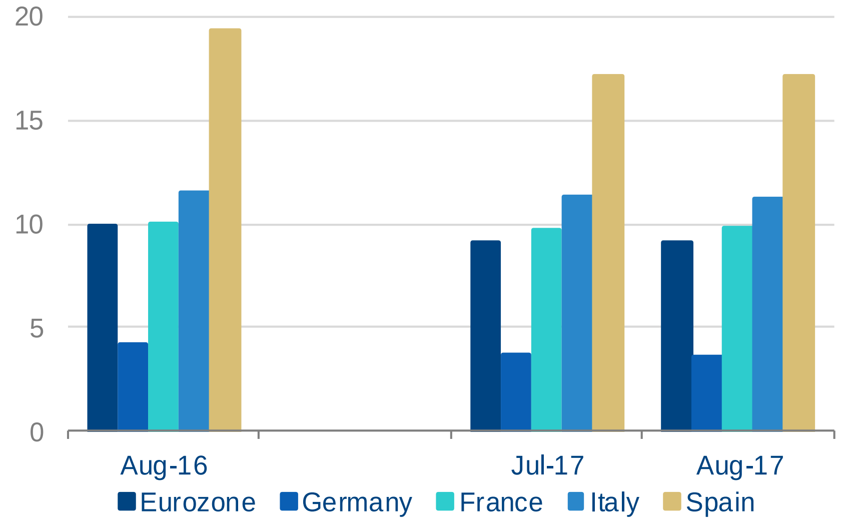


Source: Eurostat and BBVA Research

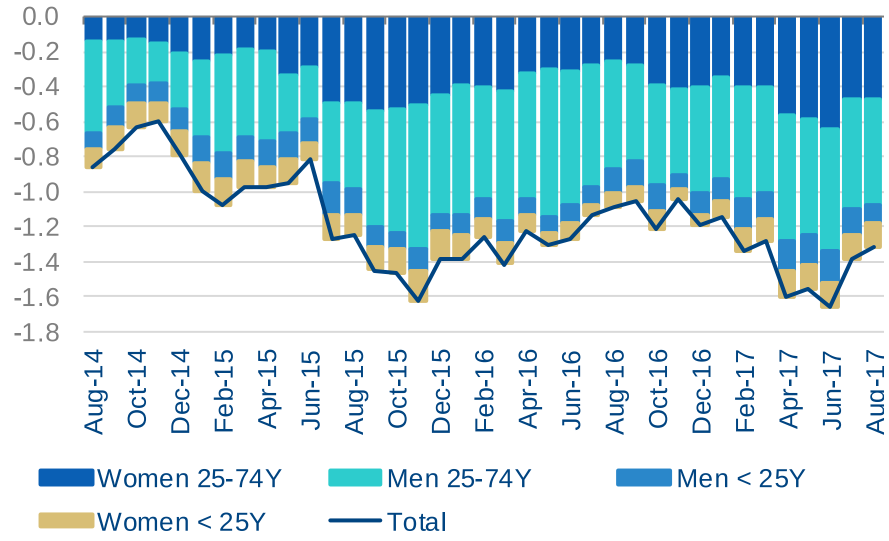
- **Retail sales dropped further in August** (-0.5% MoM) and showed its second consecutive monthly decline (-0.3% MoM in July)
- **Consumption growth continues to be driven by gains in employment and low inflation**

The unemployment rate remained stable in August, but hides ongoing improvements in the labor market

Unemployment rate by country
(%)



Annual unemployment change by gender & age
(millions)

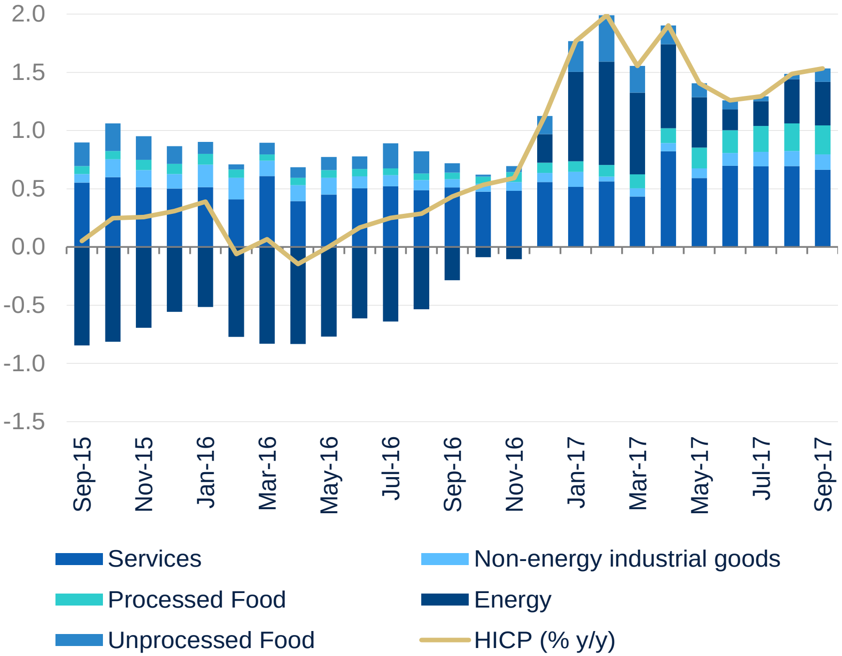


Source: Eurostat and BBVA Research

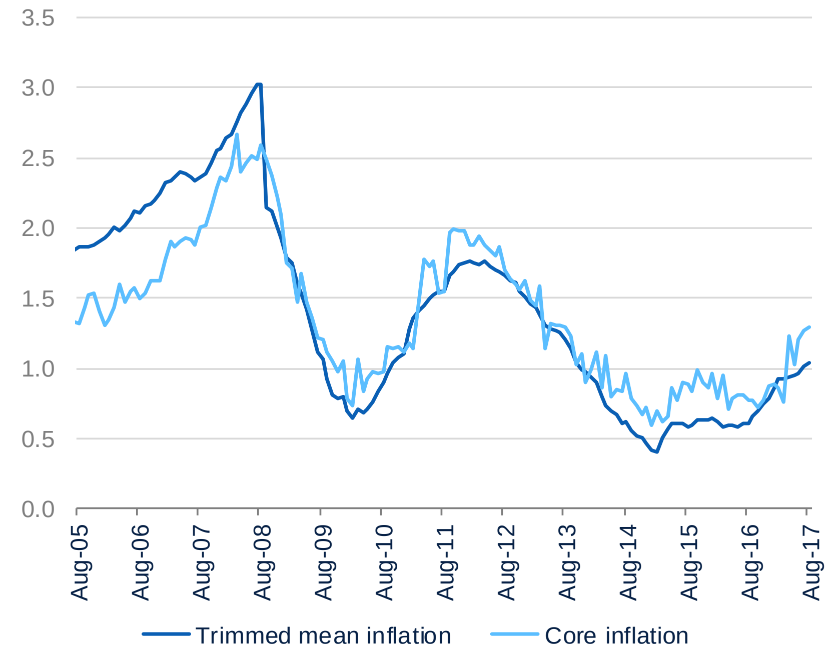
- **The jobless rate remained stable at 9.1% in August,** while the decline over the last year of 0.8pp is mostly driven by Spain and to a lesser extent by Germany
- **The unemployment fall continues** and is observed mostly among **the experienced population**

Both headline and core inflation kept steady in September

Inflation and contribution of components
(%YoY, pp)



Core and trimmed-mean inflation
(%YoY)



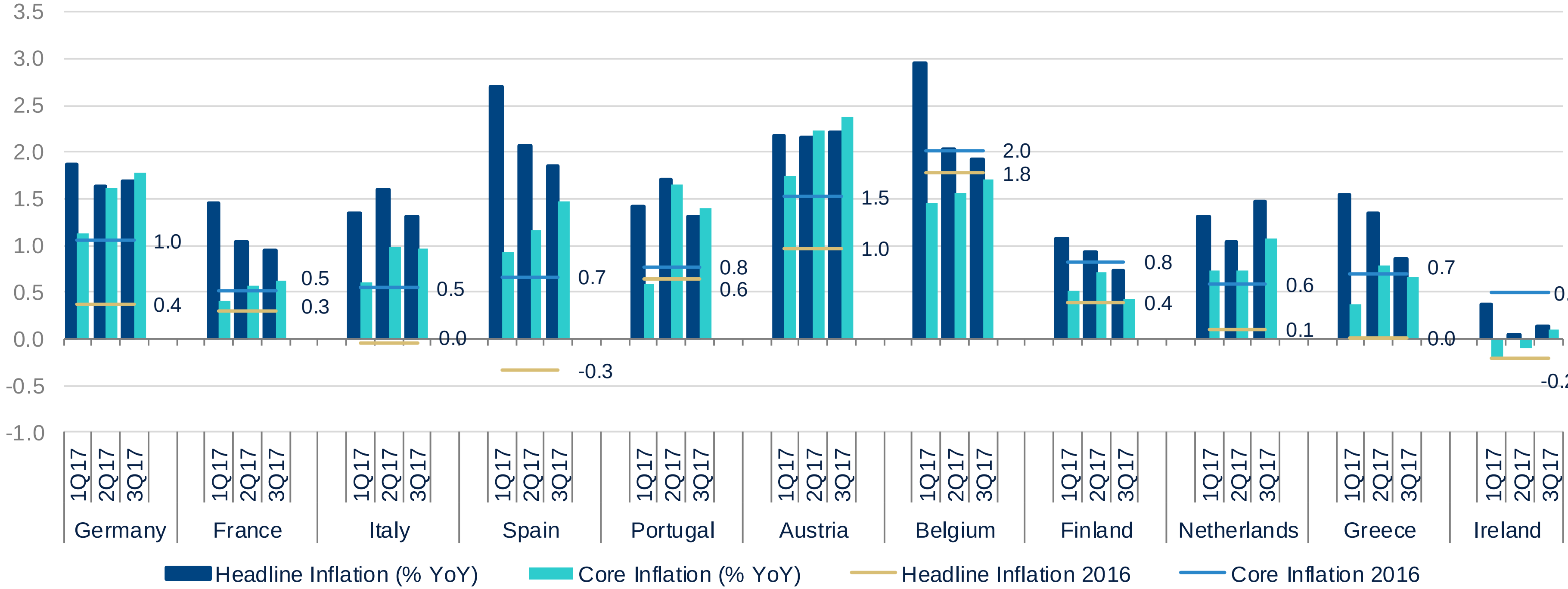
Source: Eurostat and BBVA Research

- Beyond the volatility of certain components of inflation in previous months, both the core (1.3% YoY) and the headline (+1.5% YoY) measures **remained unchanged in September**
- Headline **inflation is expected to moderate to around 1%** in coming months due to energy prices, while **core inflation should increase only very gradually**

Inflation measures remain subdued across countries during September

Headline and core inflation

(%YoY)



Source: Eurostat and BBVA Research

- **September HICP showed some mixed signals across countries:** increase in **France** (1.1% after 1.0% YoY), stable in **Germany** (1.8% after 1.8% YoY), while declines in **Italy** (1.3% after 1.4% YoY) and **Spain** (1.8% after 2.0% YoY). **This was also reflected in core measures**: unchanged in Germany and France, but declining by 0.1pp to 1% YoY in Italy and by 0.4pp to 1.2% in Spain.

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Updated forecasts:

Higher growth due to strong domestic demand, but more subdued inflation

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Growth drivers for the Eurozone

Robust and steady global growth

Robust global trade continue to support the EZ recovery

More appreciated euro

Limited effect so far, but it could weigh on exports and push inflation slightly down

Solid consumption and investment

Benefiting from strong confidence, improving labour market and financial conditions

Ongoing adjusting imbalances

Both public and private sectors, with heterogeneity across countries

Supportive economic policies

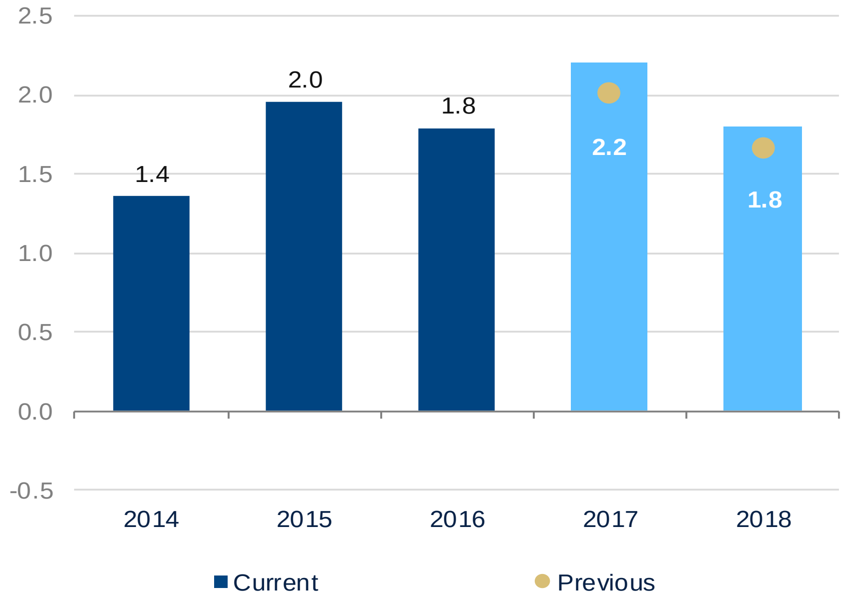
More gradual ECB's exit and slightly expansionary fiscal stance

High political uncertainty

Brexit, Italy populism, Spain, a less pro-European Germany

Eurozone: higher growth thanks to the strength of domestic demand

GDP growth and forecast
(%)



Source: Eurostat and BBVA Research

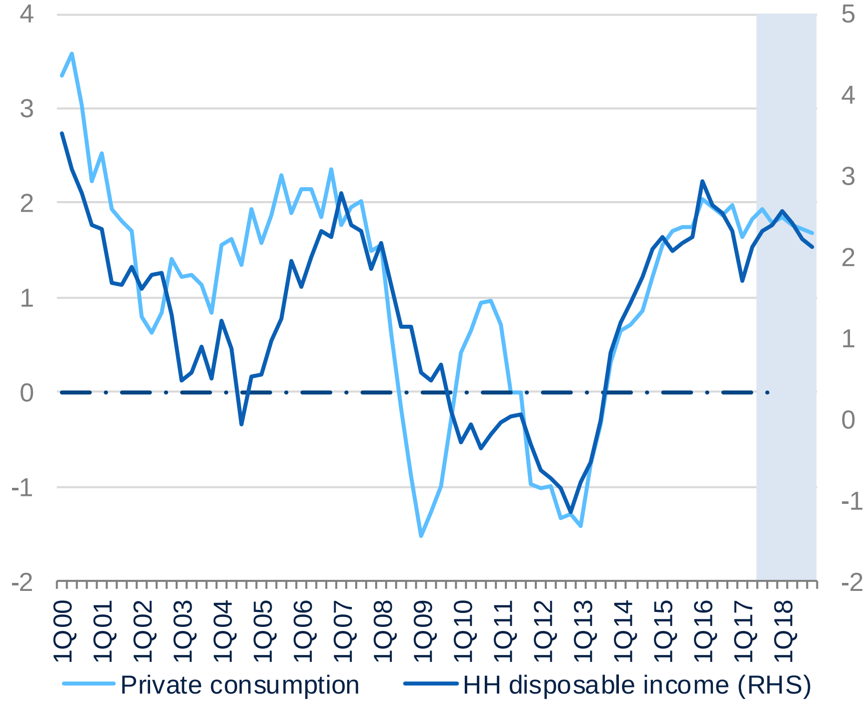
Main macroeconomic indicators
(% YoY, %GDP)

	2015	2016	2017 (f)	2018 (f)
Real GDP	**2.0**	**1.8**	**2.2**	**1.8**
Private consumption	1.8	2.0	1.8	1.7
Public consumption	1.3	1.7	1.3	1.3
Investment	3.0	4.5	4.0	3.7
Domestic demand (cont. pp)	**1.9**	**2.3**	**2.1**	**2.0**
Exports	6.1	3.3	4.7	2.9
Imports	6.5	4.7	4.7	3.5
Net exports (cont. pp)	**0.1**	**-0.5**	**0.2**	**-0.2**
Current account (% GDP)	3.2	3.3	3.2	3.0
Budget balance (% GDP)	-2.1	-1.5	-1.2	-1.1
HICP (avg. %YoY)	0.0	0.2	1.5	1.2

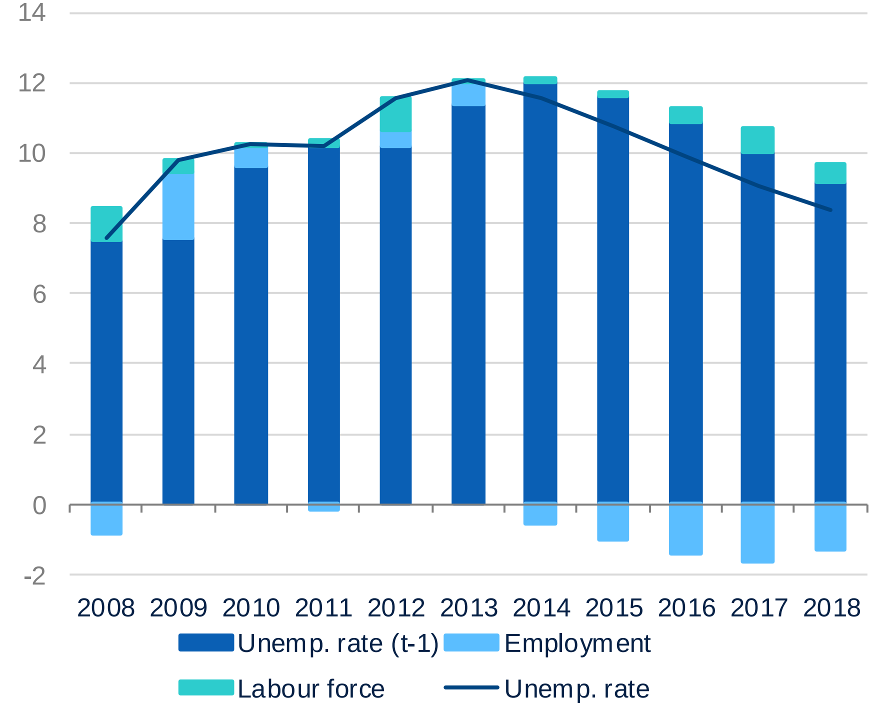
- **Stronger consumption and investment,** while the negative effect of euro appreciation seems to be limited
- Lower inflation due to a stronger euro, but **core inflation is still expected to increase gradually**
- **Easing tailwinds** in coming quarters (higher oil prices, stronger euro, stable global growth) **underpin our forecast of a slight growth moderation next year**

More resilient consumption in 2017-18

Eurozone: private consumption and real labour income (% YoY)



Eurozone: unemployment rate and contributions (%, pp)



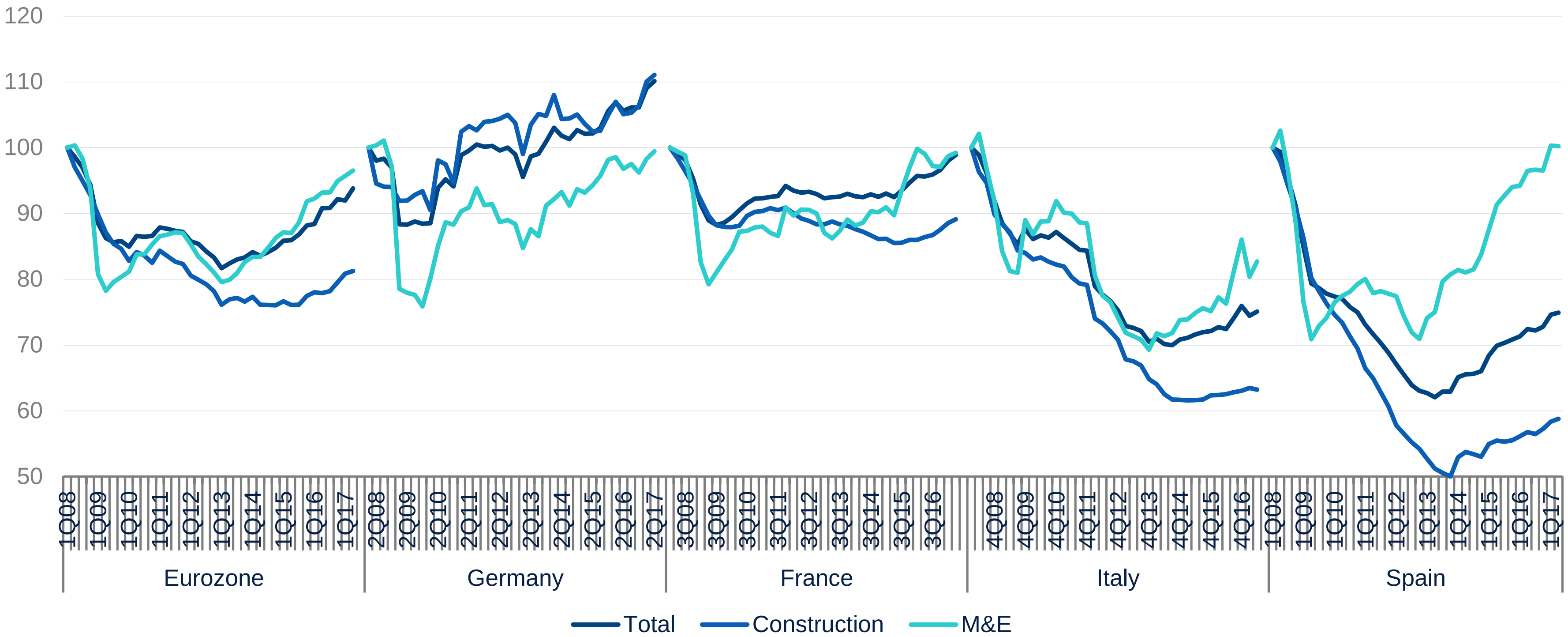
Source: Eurostat and BBVA Research

- Despite still moderate wage growth, lower prices…
- … add to the better performance of the labour market

Broad-based investment recovery on track: strong upward trend in equipment and construction after the completion of adjustment

Eurozone: investment by country

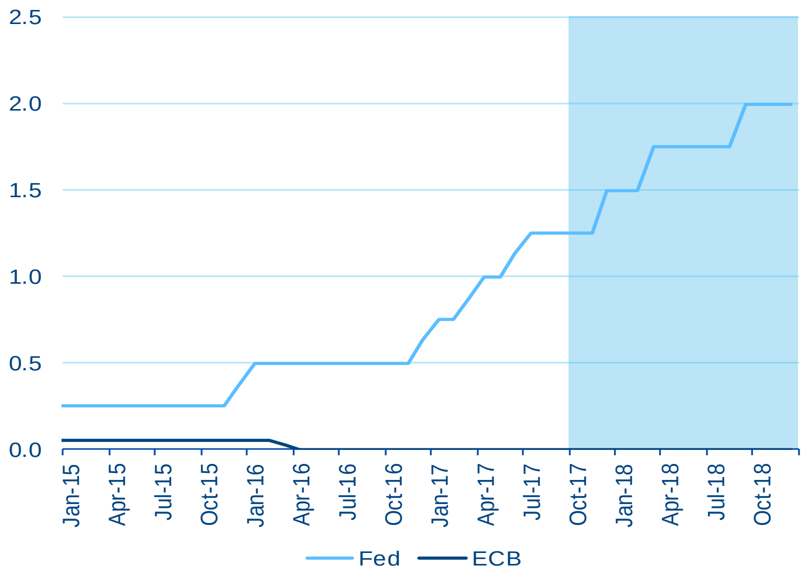
(1Q18=100)



Source: Eurostat and BBVA Research

A more gradual ECB's exit strategy: tapering in 2018, but no refi rate hike until mid-2019

FED and ECB interest rate reference
(pb)



- The ECB is not in a hurry and **normalization is expected to be orderly and prudent**. The taper plan will be unveiled at October meeting. Key elements:
  - **Retaining enough flexibility** to respond to economic develpments, mainly core inflation
  - **The recalibration of QE is expected to give priority to longer extension** (until Sep2018) with a greater reduction in the monthly pace of asset purchases (EUR from 60bn to 20-25bn) in order to anchor interest rates expectations
  - **Reinforcing forward guidance** (*interest rate at present level until "well past" the purchases*).

- All in all, **QE tapering to start in January 2018 and to end over by 3Q18.** We now expect the first **refi rate hike in June 2019**

Source: Fed, ECB and BBVA Research

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