Economic Watch
Europe

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Economic Analysis

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Recovery in the eurozone continued in the third quarter, although at a slower pace

The widespread improvement in confidence in 3Q13 is not reflected to the same extent in real indicators

- **Confidence indicators for 3Q13 as a whole show that recovery is underway, including the peripheral countries**

The confidence indicators for the third quarter as a whole show a positive outlook, pointing to ongoing improvement in economic activity throughout the eurozone following the slight upward surprise of the 0.3% q/q GDP growth in 2Q13 (BBVA Research: 0.2% q/q). In particular, both the results of the European Commission's survey and the PMIs improved significantly and above expectations in July and August, with a somewhat more moderate gain in September. Despite the positive surprises, September data might suggest that the pace of recovery in the eurozone could be stabilizing.

The PMI indicators for the monetary union are already above 50 points for the third month in a row (Chart 1) and have reached levels not seen since the first half of 2011, when GDP grew on average around 0.4% q/q. The European Commission's economic sentiment indicator continued to improve since May and is somewhat below its historical average (0.3 standard deviations below), suggesting that the economy will continue to grow at a slightly slower rate than its historical average (0.4% q/q). In addition, the improvement in these indicators has been widespread by sector (Chart 2), in line with the more balanced growth already observed in the second quarter, with the recovery of exports already revealing a more dynamic domestic demand, especially in investment.

By country, the improvement of these indicators was greater in the periphery (Charts 3 and 4), continuing with the trend already registered in the second quarter. Specifically, the PMIs for Italy and Spain already reached 50 points and suggest a certain stabilization of their economies or even weak growth in the third quarter.

- ## The activity indicators, although still very limited, do not show such positive signs, and are more in line with a weak and slow exit from recession

The most worrying signs come from the decline registered in industrial output in July (-1.5% m/m), which offset the weak increase seen at the end of the second quarter, and suggests a worsening of industrial activity compared to that period. However, the qualitative data continue to show a more optimistic outlook in industry for both August and September. By country, industrial output in Germany grew by 1.4% m/m in August, offsetting the fall registered in July (revised upward by +0.6pp to -1.1% m/m), although the data up to August continue to suggest a slowdown in industrial activity (0.6% on 2Q13, when it increased by 1.5% q/q). In both Spain (around 0.2% m/m also in July and August) and, particularly, Portugal (8.2% m/m in August following the -2.2% m/m decline registered in July) an increase in industrial output was also seen in August.

Domestic demand data are more encouraging. Retail sales continued to increase in August and suggest that the weak growth in private consumption registered in 2Q13 could continue or even accelerate slightly in 3Q13 (Chart 5). This increase in household spending would be reflecting the improvement in consumer confidence in recent months, supported mainly by the stabilization of the labor market so far this year (practically stable at 12%). The slow recovery of industrial output, together with the restrictive lending conditions and unutilized capacity of companies, anticipate a very moderate investment growth. Lastly, the public balance figures show that the fiscal consolidation process has slowed down and, as already seen in 2Q13, it is likely that public consumption will not end up weighing on growth.

The foreign sector data (seasonally adjusted) suggest that exports in July continued to support growth (Chart 6), while the still robust global growth (despite a certain slowdown in emerging economies) should continue in the coming months. However, imports are also growing, although at a slower rate, and this trend is expected to continue in the coming months supported by the greater dynamism of domestic demand. It is thus likely that the positive contribution from net exports has eased.

- ## The MICA-BBVA model suggests that the recovery continued at a weak pace in 3Q13, with some differences by country

Our short-term model (MICA-BBVA) suggests that the recovery continues and at a relatively stable pace, estimating a quarterly growth of +0.2%/+0.3% q/q for 3Q13 (Chart 7), practically in line with our scenario published in August (+0.3%). However, following the rebound in activity seen in some Central European countries, especially in France and Germany, we cannot rule out a slight slowdown for the eurozone as a whole, with the disappearance of some of the temporary factors that underpinned this growth (investment in construction and inventories).

Specifically, we now expect that economic growth in Germany and France will slow down in 3Q13 to 0.4% q/q and 0.1% q/q (from 0.7% and 0.5%, respectively), while the peripheral countries could already be emerging from recession (Spain: 0.0%/+0.1% q/q; Portugal: +0.1%/+0.2% q/q), or becoming practically stagnant (Italy: -0.1%/0.0% q/q).

- **Inflation slowed down in August and September, in line with expectations**

  Inflation fell by 0.5pp in August and September to 1.1% y/y, due mainly to falling prices in the energy component (slightly above -0.3pp), but also to moderate increases in food prices (around -0.2pp), while inflation in the services and non-energy industrial goods components remained practically stable. For the coming months, our forecasts consider a slight increase in headline inflation to around 1.4% in December due to the reduction of the base effect of energy prices, while core inflation should remain relatively stable. For 2014, inflation will remain clearly below the ECB target.

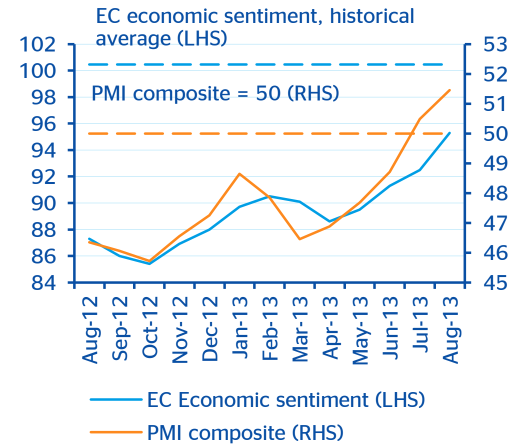
- **In this context, monetary policy will continue to be accommodative, while fiscal policy will be less restrictive**

  Given this outlook, the ECB has been cautious when assessing the recent activity data and, in line with our scenario, envisages a slow and moderate recovery within the forecast horizon, with inflation forecasts clearly anchored below 2%. The main concern of the monetary authority continues to be the fragmentation of the financial markets and the interruption of the operation of the traditional mechanisms for transmitting monetary policy. If the foregoing is included in its new forward guidance strategy, an accommodative monetary policy should be maintained for the forecast horizon, without ruling out another rate cut or a new injection of liquidity in the coming months.

  As for fiscal policy, the latest data on budget execution to September suggest that most countries are on the way to meeting the new fiscal targets redefined in spring (although some deviations cannot be ruled out), and show a moderation in the pace of fiscal consolidation established previously. This will continue next year, as reflected in the various national budgets presented recently, with a fiscal effort clearly less ambitious than that envisaged in the stability programs. In short, this slower pace in the adjustment of public balances, more focused on the structural component to avoid compensating the cyclical worsening, should weigh less on economy recovery.

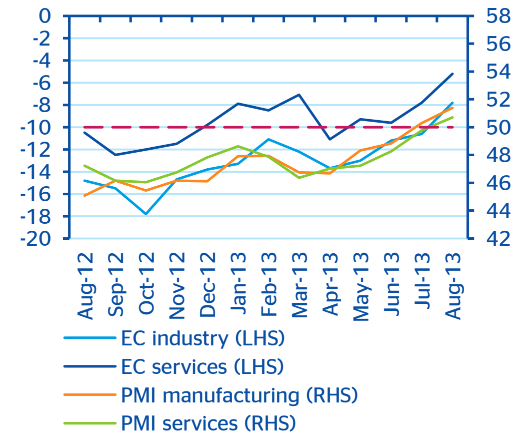
The significant gain in confidence data in 3Q13 suggests that the recovery is gaining momentum across sectors

Chart 1
EMU: Confidence data



Source: European Commission, Markit Economics and BBVA Research

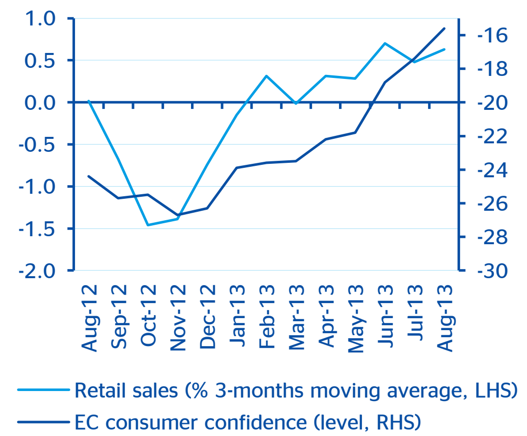
Chart 2
EMU: Confidence data



Source: European Commission, Markit Economics and BBVA Research

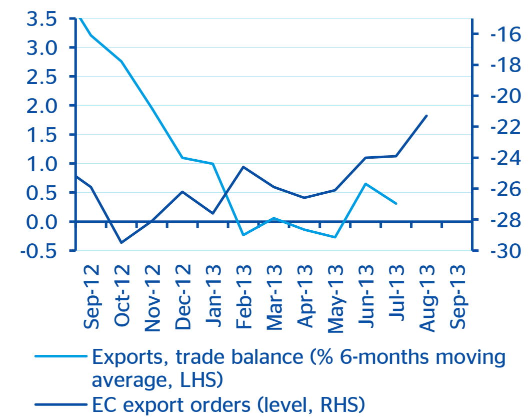
Hard indicators, although still limited, point to an incipient recovery in private spending, while exports continue to support economic growth

Chart 3
EMU: households consumption



Source: Eurostat, European Commission and BBVA Research

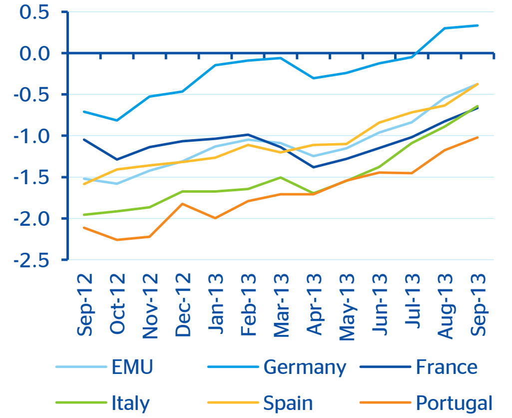
Chart 4
EMU: exports



Source: Eurostat, European Commission and BBVA Research

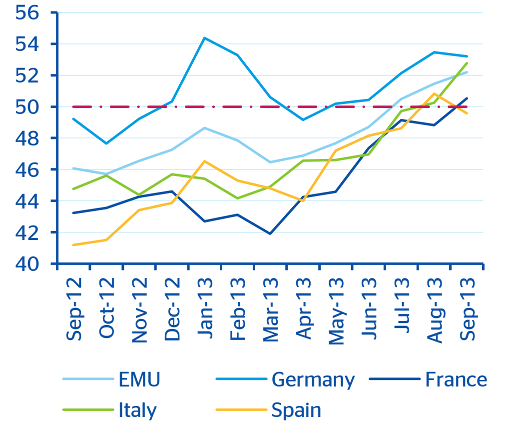
Improving soft indicators were stonger in the periphery, suggesting an economic stabilization or a slight growth in these countries

Chart 5
European Commission confidence indicators by country (standardized)



Source: European Commission and BBVA Research

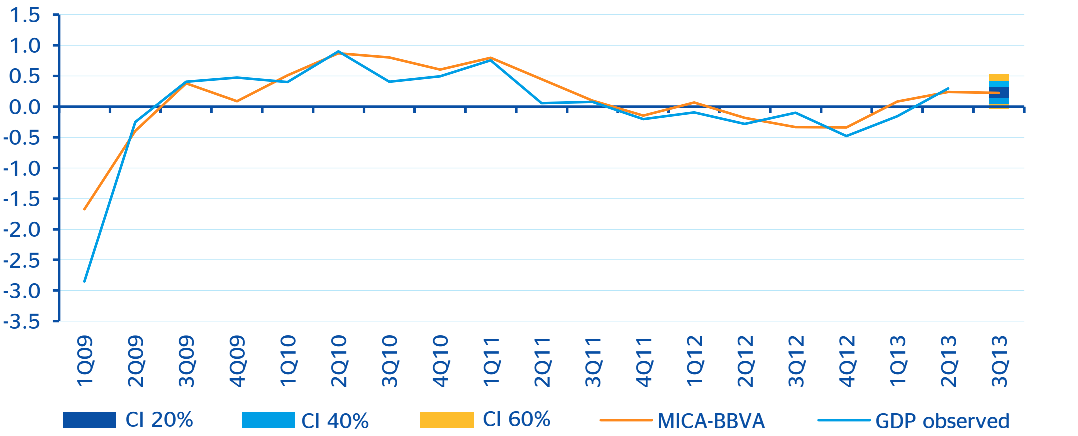
Chart 6
PMI confidence indicators by country



Source: Markit Economics and BBVA Research

Our MICA-BBVA model projects a mild consolidation, but at a steady pace. GDP is forecasted to grow by +0.2%/+0.3% q/q in 3Q13

Chart 7
Quaterly GDP growth and MICA-BBVA forecast



Source: Eurostat and BBVA Research