MACROECONOMIC ANALYSIS

Strong growth and job creation open up the prospect of earlier-than-expected monetary policy normalisation

Europe Unit

We are expecting normalisation in 1Q15, and a more gradual rise in interest rates, which will make it easier to ramp up fiscal consolidation after the elections

- ### Solid and stable growth continues in 2Q14, supported by strong domestic private spending…

  Preliminary GDP figures for 2Q14 put growth at 0.8% QoQ (similar to that registered over the last year), with the services sector the main source of growth (making a contribution of 0.8pp by growing 1% QoQ) and, to a lesser degree, the industrial sector (just under 0.1pp with growth of 0.4% QoQ), while agriculture contributed nothing and construction was slightly negative.

  Although the breakdown of GDP on the demand side is not yet known, the information above, together with the available figures, suggests that domestic demand is mainly responsible for this robust growth (Figures 1 and 6), in both private consumption (retail sales were up strongly, by 1.6% QoQ) and investment, although the latter's rate of progress may have slowed slightly (in line with the moderation in production of intermediate and capital goods, as well as the slight contraction in the construction sector). In terms of the foreign sector, balance of trade figures suggest that the contribution of net exports will continue to fade away (between 0pp and 0.1pp, slipping from 0.3pp in 1Q14 and 1pp in 4Q13), given that nominal exports contracted again (-0.7% to May), although at a slower rate, while imports expanded a little after the sharp fall in the first quarter (Figures 7 and 8).

- ### … with hearty job creation, but no pressure on wages …

  The high rate of job creation which has been recorded for the last year continued into the first quarter, rising by a little more than GDP (0.9% QoQ; 2.4% YoY) and at double the rate of the economically active population (0.5% QoQ; 1.3% YoY), which led to a significant 0.5pp reduction in the unemployment rate to 6.7% (down 1.1pp over the last year) and a slight fall in productivity. Data available to date for the second quarter show that the unemployment rate has gone down again, to 6.6% (Figure 9).

  Despite the significant improvement in the labour market over the last year, the increase in wages has been moderate (a little more than 1% on average), and data available to May point to this moderation continuing (0.3% in the last three months compared to a year ago), after the uptick in the first quarter (1.9% YoY), which was conditioned by the payment of bonuses (Figure 10).

- ### … increasing the uncertainty about the economy's spare capacity, which has important implications for monetary policy

  The Bank of England (BoE) is weighing up two possible explanations for the labour market's momentum, with different implications for the process of normalising monetary policy. On the one hand, wage restraint may be accounted for by the gap between job creation and wage increases, which may be greater than expected. If this is so, after the healthy rate of job creation recorded over the last year, there could soon be wage increases in the next few quarters. Data collected from several surveys continue to be inconclusive on this point. On the other hand, wage restraint could be a consequence of a greater increase in the active population, implying, furthermore, that the economy's spare capacity has been undervalued. Alternatively, it is also possible that the demand for work has centred on less-qualified employment and on the long-term unemployed, which would also account for the disappointing performance of productivity. These two final alternatives would not imply greater pressure on wages in the short term, due to a greater deterioration in the economy's spare capacity as a result of structural factors.

- ## Strong growth expected for 2014-15, supported by solid domestic demand, especially in investment

In the last three months, the underlying factors in the performance of the British economy have behaved as expected. The solidity of domestic factors (more employment, less inflation, strong improvement in confidence and in funding conditions, with the commitment to the continuation of an accommodative economic policy) will enable internal demand to continue driving activity at steady rates throughout the forecast horizon.

In general terms, we have not changed our growth scenario from three months ago, although we now expect slightly more growth in the second quarter than we had previously foreseen (+0.1pp) and the figures available to date have led us to revise our GDP growth forecast for 2014 and 2015 slightly upwards, to 2.9% and 2.5% respectively. As such, we continue to expect a slight moderation in growth in forthcoming quarters, although we are still anticipating a solid increase (around 0.6% QoQ on average in the forecast horizon), somewhat higher than our estimate of potential growth (around 2%).

The upturn in investment will be the main determinant of the strong increase in production, together with the resilience of private consumption and a greater contribution on the part of foreign demand (although doubts persist because of the strength of the pound and the timid recovery in the eurozone).

Expectations of low interest rates over a long period, as well as better access to borrowing by companies (after the extension of the Funding for Lending Scheme) will continue to make investment easier (around 8% in 2014 and 6.6% in 2015), especially since the capacity usage in companies is already at record highs. On the other hand, job creation, together with the increase in nominal wages (without wage pressures because of the increase in productivity) and a moderate rate of inflation, will impact on an increase in available household income, at the same time as the reduction in the rate of savings for precautionary motives may continue in the future. All of this will be reflected in an increase in private consumption of rather more than 2% in 2014 and 2015, although at a slower pace than before the crises due to the on-going process of private sector's deleveraging. The significant moderation in public consumption since the end of 2013 ought to continue this year and next, in order to comply with the on-going fiscal consolidation process, although the government's commitment to implement a neutral budget in 2014 remains firm. Net exports will again contribute positively to GDP growth (0.2pp in 2014 and 0.2pp in 2015), but less so, since exports (limited by the strong pound and a higher increase in domestic prices over the euro area) will not grow much more than purchases from abroad made in order to meet domestic demand.

Finally, when it comes to the labour market, the upward trend is expected to continue over the next few quarters, although the reduction in unemployment will be more moderate from the second half of the year onwards; thus we expect the unemployment rate to come in at around 6.3% at the end of 2014 and to fall to 6% in 2015.

The uncertainty around this scenario remains high; the risks linked to potential negative effects from the economic policy normalisation in a year with general election in sight along with the uncertainty around the spare capacity in the economy, now bind the potential consequences stemming from the conflict in Ukraine and the results of the independence referendum in Scotland.

- **Inflation will continue to hover slightly below the BoE target in the forecast horizon, making communication to bring forward the rises in interest rates difficult**

  The moderation in inflation since the middle of last year has continued in 2Q14, recording an annual rate of 1.7% YoY over the quarter (after 1.8% in 1Q14), due mainly to the behaviour of food prices, while underlying inflation was fairly stable at 1.9% YoY (Figures 11 and 12). The rebound of inflation in June (to 1.9% YoY) was largely a reaction to the seasonal adjustment because of the summer sales, so we hold to our scenario that inflation will continue to move slightly below the BoE's target over the forecast horizon, coming in with an annual average inflation rate of 1.7%, in both 2014 and 2015. The strong pound is the underlying factor behind this scenario, together with the lower price of raw materials, as well as restraint in wage rises.

- **The BoE prepares the ground to start raising interest rates, which we now expect for the first quarter of 2015**

  The members of the Monetary Policy Committee have started preparing the ground for bringing forward the start date for monetary policy normalisation, making their statements more dovish in the light of the latest figures and in line with the second phase of their forward guidance strategy. In particular, they continue to emphasise that in view of increased uncertainty, monetary policy decisions are clearly dependent on the data that is published and, in the light of the possibility that pressure on wages will return in the forthcoming quarters (if the expected uptick in productivity does not happen) and, consequently, on inflation, they believe that it would be better to anticipate the interest rate hikes. This will also enable the process of normalisation to be more gradual in the medium term (and always conditioned by the data as they are known) with a combination of more favourable economic policies once the process of fiscal consolidation is strengthened next year after the elections.

  In the light of our economic scenario, we now expect the first rise in interest rates to take place in the first quarter of 2015 (instead of 2Q15, as expected three months ago, but not at the end of 2014, as some parties in the consensus expect), since the slight moderation in growth from the second half onwards, together with the slowdown in inflation in the absence of new inflationary pressures, will provide a margin for maintaining monetary policy for the rest of the year, without risking the rate of economic progress, particularly when there are still factors which might weaken growth. Once the cycle of interest rate rises has begun, the rate of these will still depend on the economic figures which, in line with our scenario, will be gradual, in the expectation that the BoE interest rates will be around 1.25-1.50% by the end of 2015.

Table 1
BBVA Research GDP and inflation forecasts (May 2014)

YoY rate	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-1.0	-3.6	1.0	-0.4	1.4	2.2	2.2	2.1
Public consumption	2.2	0.6	0.5	0.0	1.6	0.7	0.5	-0.1
Gross fixed capital formation	-6.9	-16.7	2.8	-2.4	0.8	-0.8	8.0	6.6
Inventories (*)	-0.2	-1.5	1.2	0.4	-0.6	0.2	0.0	0.0
Domestic demand (*)	**-1.6**	**-6.1**	**2.1**	**-0.1**	**0.8**	**1.7**	**2.6**	**2.3**
Exports	1.1	-8.7	6.7	4.5	1.7	0.5	1.0	3.8
Imports	-1.7	-10.7	7.9	0.3	3.4	0.2	0.0	3.2
Net exports (*)	**0.9**	**0.9**	**-0.5**	**1.2**	**-0.5**	**0.1**	**0.3**	**0.2**
GDP	**-0.8**	**-5.2**	**1.7**	**1.1**	**0.3**	**1.7**	**2.9**	**2.5**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.6**	**1.7**	**1.7**

(*) Contributions to growth.
Source: BBVA Research

United Kingdom

National accounts: solid and stable growth in 2Q14

GDP grew by 0.8% QoQ in 2Q14, supported by the services sector and, to a lesser degree, by industry. Data available point to strong domestic private spending, while support from the foreign sector is fading away. For 3Q14, growth may moderate slightly.

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

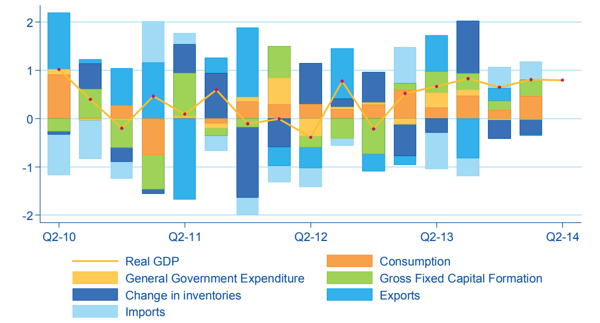
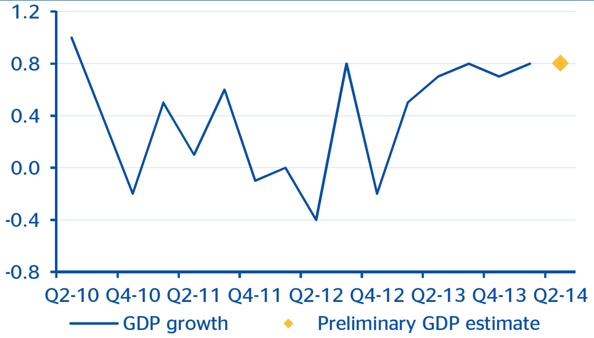


Figure 2
GDP growth (%QoQ) and preliminary estimate



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)*

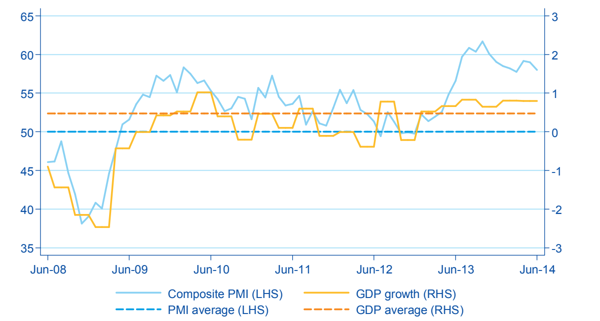
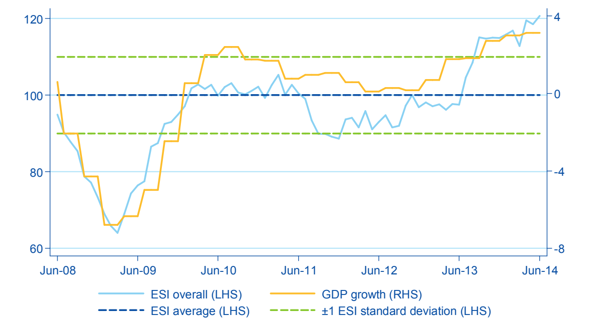


Figure 4
Confidence (ESI) and GDP growth (% YoY) **



Activity: investment and consumption move forward at a steady pace

Industrial production progressed in 2Q14 at a slightly slower rate. The improvement in retail sales points to solid growth in private consumption in the second quarter of the year.

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

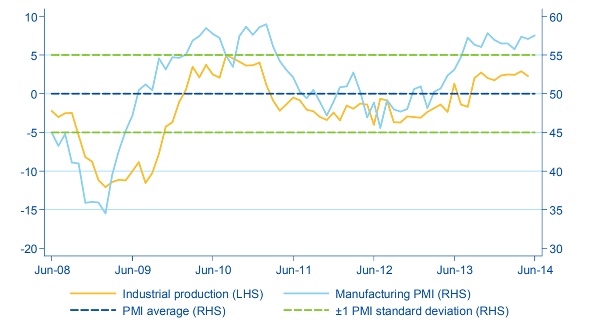
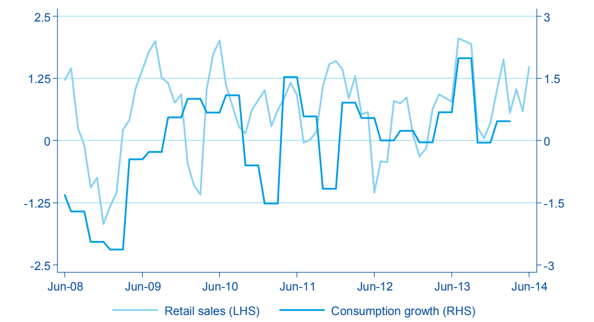


Figure 6
Retail trade (% 3m/3m) and consumption growth (%QoQ)*



*Source: HAVER 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 evaporate (between 0pp and 0.1pp in 2Q14 after 0.3pp in 1Q14 and 1pp in 4Q13).

Figure 7
Trade balance (% of GDP)*

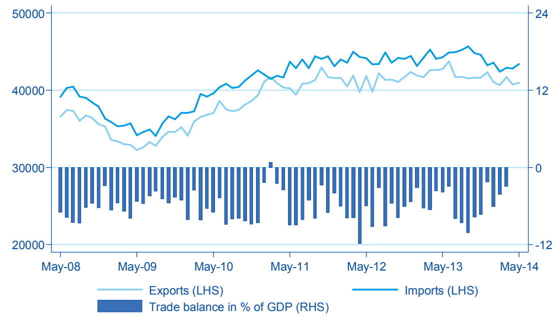
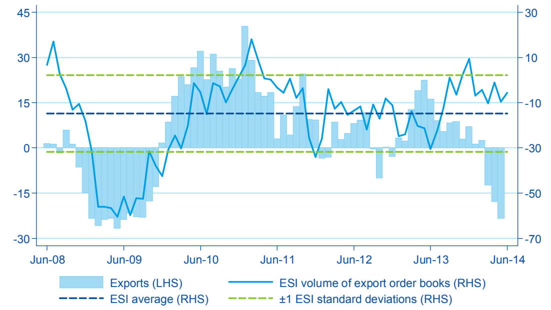


Figure 8
Export growth (%YoY) and volume of export order books*



Labour market: strong job creation, without pressure on wages

The unemployment rate continued to fall to 6.5% in the three months to May. Wage rises remain moderate, after the uptick in the first quarter which was conditioned by the payment of bonuses.

Figure 9
Unemployment rate (%) and employment expectations*

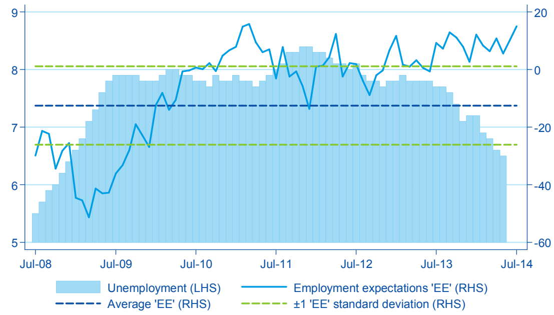
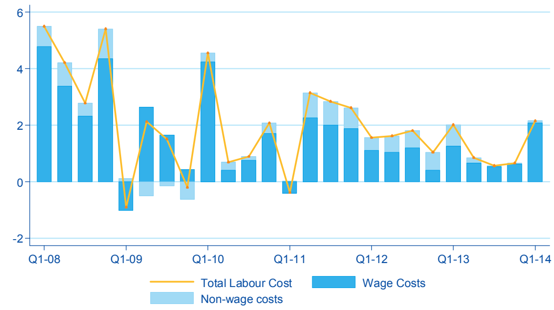


Figure 10
Labour cost in the business sector (%YoY)*



Prices: inflation will continue hovering below 2%

Moderation in inflation in 2Q14, because of the behaviour of food prices. The uptick in June was due to the different seasonal adjustment caused by the summer sales. The strong pound, the lower price of raw materials and moderate wage inflation underpin our scenario.

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

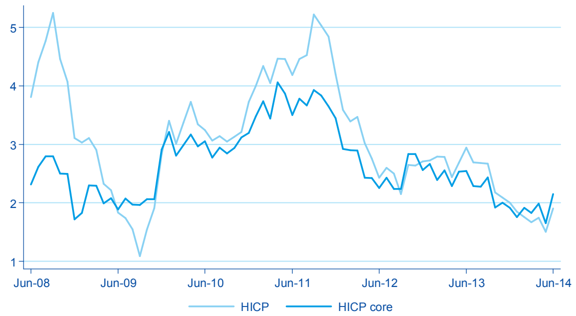
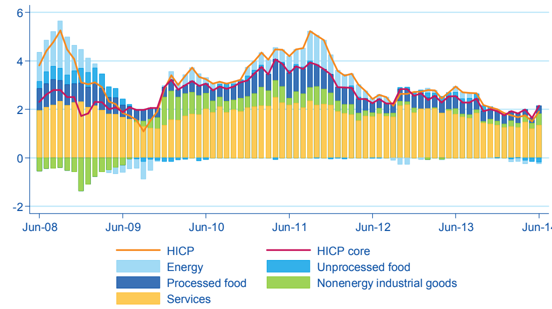


Figure 12
Inflation by components (contribution in %)*



* Sources: HAVER and BBVA Research

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