MACROECONOMIC ANALYSIS

More moderate growth and a BoE more given to deferring the rate hike

Europe Unit

Over recent months the domestic factors underlying the economy's progress have behaved much as expected (increased employment, confidence holding up, commitment to accommodative monetary policy and practically the same fiscal adjustment), but certain external factors have shown more shakiness, which leads us to revise growth and inflation down a shade in the short term. The risks remain to the downside, while domestic price pressure is weak, for which reason the Bank of England (BoE) has shown itself more inclined towards delaying the first rate hike in recent months, and we now see this taking place in 2Q16

Growth eased up in 3Q15, as expected, weighed down by net exports, yet propped up by lively domestic demand…

GDP growth slowed down by 0.2pp to 0.5% QoQ in 3Q15, held back by the strongly negative contribution of net exports (-1.5pp) and confirming that the positive surprise these provided in the previous quarter (+1.4pp) was only temporary and unlikely to be sustained. Sales abroad lost pace again in 3Q15, hit by the slowdown among the emerging economies and still suffering from sterling strength, while imports picked up, which was partly associated with the upturn in inventories (+1pp after -1.6pp in 2Q15). Discounting this quarterly volatility, net exports are likely to have had a slight sapping effect on growth so far this year. On the other hand, **domestic demand excluding inventories contributed around 1pp to growth in 3Q15, just as it had during the first half of the year,** which was also a little above the average of 0.7pp that it had been contributing since 2013 (Figure 1). Looking at components, private consumption remained strong despite easing up a bit (0.7% QoQ after 0.9% in 2Q15), and investment continued to fluctuate around the 1.3% mark QoQ, while public sector consumption rose by slightly more than had been anticipated (1.3% QoQ from 0.4% in 2Q15).

The **figures out so far for 4Q15 are basically confined to confidence surveys and are a mixed bag** (Figures 3 and 4), as on the one hand the European Commission indicators came down again in November (for the third straight month) as a result of the sharp drop in industrial sector expectations, whereas consumer and services sector confidence showed improvement, holding up at levels ahead of their historical averages. On the other hand, the PMIs were up in October and partly regained the ground lost in September on account of the better showing in both services and, above all, manufacturing, which has kept them up at levels comparable to those of 3Q15. These figures are in line with our scenario **whereby the economy would manage to continue to forge ahead at a relatively stable pace in 4Q15 (of around 0.5% QoQ),** riding on the strength of domestic demand, and thus more moderate quarterly growth rates relative to those seen in the two years previously (in the 0.7% to 0.9% range) ought to stabilise (Figure 2).

… with certain signs of flagging in the labour market, a fall in productivity and sustained wage rises, although these have not accelerated

Despite the encouraging developments in the labour market, certain signs of weariness are still being observed in 3Q15, with **recruitment of full-time employees at a standstill for the second quarter in a row** (having grown by about 0.4% QoQ on average since 2014) and **the participation rate** (16-64 yearolds) **hitting highs** within the series on record since the 70s (78%, around +1.5pp since 2010). Employment growth (0.6% QoQ after stagnation in 2Q15) therefore came from **lively hiring of part-time staff** (0.4pp) and **might partly explain the steadying up of the rise in wages in September** (3% 3M/Y) **as well as the slight drop in productivity** (-0.1% QoQ, 0.9% YoY since the figure of 1.3% for 2Q15). Given the uncertainty over measurement of the spare capacity in the economy (which the BoE still estimates at 0.5% of GDP, thence disappearing over the forecast horizon), **wage trends have emerged as a key variable in shaping monetary policy over the next few months**. The above figures, together with the surveys which reveal that firms are finding it hard to recruit new workers, could be grist to the more hawkish section of the Monetary Policy Committee (MPC), which interprets them as increased inflationary pressure arising from the ongoing take-up of the economy's idle capacity that is not being accompanied by any rise in productivity (Figures 9 and 10). Even so, the volatility of these figures gives us the impression that the broad majority of MPC members will remain dovish, as, on the one hand, greater wage growth will have to materialise in the coming months and doubts have to be dispelled over the potential impact of the drop in inflation expectations on wage bargaining processes, while, on the other hand, given that increased investment could end up by boosting productivity, the rate of labour cost growth is still not consistent with the BoE's inflation target.

Inflation continued to fluctuate at around 0% YoY and will still be determined by commodity prices and the strength of sterling

Inflation has been hovering at around 0% YoY so far this year, **essentially because of the steadying of the fall in energy and food prices**. Meanwhile, **core inflation has also held fairly stable at around 0.8% YoY**, with services prices rising at a clip of about 2.3% YoY, whereas the drifting of non-energy industrial goods prices appears to have begun to moderate in October (Figures 11 and 12).

Looking ahead to the next few months, **our forecasts suggest that inflation might pick up to close to 1% YoY in 1Q16** as a result of the energy and food price base effect, then stay wavering at around 1.2% YoY over the middle of the year and thereafter creep up towards the end of 2016, to rates of slightly below 2% in 2017. As a result, **we are standing by our forecast that annual average inflation will come in at 0.1% in 2015, although we are revising 2016 inflation down by 0.2pp to 1.3%** on the back of lower commodity prices and sterling strength. Risks remain tilted to the downside.

The forecasts in the **November Inflation Report (IR)** also point in this direction. According to this, the low commodity prices and the strength of sterling potentially account for around four-fifths of inflation's deviation from its 2% target. Oil prices 14% lower than those in the August IR and somewhat stronger sterling were reflected in a **0.2-0.3pp downward revision of inflation** for this year and the next (0.1% YoY in 4Q15, 1.2% in 4Q16), but with smaller changes (around 0.1pp) for 2017 (2% in 4Q17). In spite of this, **they still expect target inflation to be hit at the end of 2017**. That said, the **MPC** has appeared **a little more concerned than before, as the low commodity prices over an extended period** (now maybe longer, which is associated with the slowdown of the emerging economies) **and the greater persistence of inflation below its target level could affect the anchoring of expectations,** especially bearing in mind that pressure on the domestic side has also been rather weaker than it had anticipated in its report of three months ago.

Forecasts for 2015-16: More moderate growth on the disappearance of stimuli, with reduced support from domestic demand

Broadly speaking, **we are maintaining our growth scenario of the past six months, which already envisaged a slowdown in the economy's pace of progress in the third quarter of the year, thereafter settling into relatively stable and still robust growth rates of about 0.5-0.6% QoQ over the forecast horizon,** a little above our estimate for potential growth of around 1.7%. This growth scenario is, and was, somewhat less optimistic than that offered by the BoE and the analyst consensus. The revised national accounts figures betrayed domestic fundamentals that were rather shakier than they had previously seemed (there was a downward revision of household disposable income, suggesting a greater reliance on a reduction of the saving rate, while the rebound in investment is likely to have been a bit less substantial than was initially estimated), which is more in keeping with our view that the rate of progress over the past two years was unsustainable. On the other hand, **the decline in global demand prompts us to lower our forecasts for both 2015 and 2016 marginally, by 0.1pp**. Thus annual average growth this year should come down by 0.5pp to **2.4% and advance by 2.2%** next year.

Forecast trends for components continue to suggest a pick-up in investment and foreign trade in 2016. The acceleration of private consumption in 2015 to a forecast rate of 2.9% (2.6% in 2014) **continues to be the main driver of growth, even though we predict that this will ease up over 2016** (2.3%) owing to labour market improvements wearing off and increased inflation, whereas the process of fiscal consolidation, in conjunction with mounting uncertainty, gives the impression that economic agents will not bring down the saving rate much further.

On the other hand, **reduced investment growth continues to be the chief reason behind the smaller GDP growth projected for this year**, above all because it had already reached pre-crisis levels at the end of 2014 and the investment-to-GDP ratio is converging on its historical average, while the slowdown among the emerging economies, and possibly the uncertainty surrounding the referendum over Brexit, might be weighing on decision-making in this regard. **Despite this, we expect investment to grow at relatively robust rates over the forecast horizon** (4% in 2015 and 5.1% in 2016, after 7.5% in 2014), nourished by expectations of low interest rates for a considerable time to come, lower energy costs and more accessible financing for firms.

The dampening of activity is also being influenced by the **ongoing consolidation of the public accounts which began this year**. In its November **Autumn Statement,** the government showed that it was committed to achieving a small surplus at the end of its term in office, in spite of the U-turn on the tax credit cuts announced in July (GBP12bn), which are partly offset by the economy's cyclical improvement and smaller interest payments. All in all, the government is still expecting a **fiscal adjustment of around 1pp of GDP this year and 1.3pp next year** (compared to the figure of 1.5pp announced in July), this being reduced gradually up to 2020 to give an average annual adjustment of about 0.8pp of GDP. A smaller reduction of spending on public investment is now expected in 2015 and 2016, taking this to 1.8% of GDP (from 2% in 2014), instead of projected investment of 1.5% in July. Thus the public sector net borrowing should come down to 3.9% of GDP in 2015-16, from 5.2% in 2014-15, and to 2.5% in 2016-17.

Finally, the rise in both exports and imports has been modest in 2015, with a **practically non-existent contribution from net exports over the year as a whole. For 2016, we expect both components to pick up speed, but to give rise to a negative contribution** (slightly less than -0.5pp) as buying from abroad should display a bolder pace to meet domestic demand.

The **domestic risks for the scenario continue to be biased to the downside** and mainly hail from the uncertainty over the results of the **Brexit referendum, which is still to be scheduled**. The Prime Minister's letter to the European Union listing the matters which the United Kingdom wishes to discuss to stay in the

EU did manage to allay some doubts. Although we think that, with regard to some of these (protecting the single market, boosting competitiveness and keeping the United Kingdom out of closer integration processes) an agreement is relatively easily achievable, the demands on immigration seem more problematic, given the current Europe-wide refugee crisis. This, together with the Scottish elections in May next year, makes it more likely that the referendum will be staged in 2017. **From outside,** uncertainty persists over **geopolitical tensions and the deceleration of the emerging economies**.

In this scenario, we expect the BoE to hold off monetary policy normalisation until the second quarter of 2016

The worsening external environment (mainly China and emerging economies) over the summer, and the greater weight of the potential adverse impact of a global risk scenario in connection with other central banks too (the Fed's delay in normalising its policy in September, above all, and the announcement of more measures by the ECB in December), combined with less domestic pressure on prices than the BoE was anticipating, have led MPC members to show a **more dovish stance since August, which has been particularly true in October and November.**

One of the major shifts has been that they appear **more concerned over the effects of inflation that is sticking below the 2% target** on price expectations, and therefore wages. This contrasts with the more optimistic message that they were conveying in the middle of the year about the positive impact which the drop in commodity prices would have on the economy, and reflects the change in the take on the external context and risks.

Besides the fact that domestic demand pressure has been less than expected, the MPC members now seem more **confident about the effectiveness of monetary policy** in controlling inflation (shorter lag in the response of inflation to interest rate changes), for which reason the most dovish members will prefer to wait for longer until they have clear evidence before making the first rate hike, and this provides grounds for a very gradual increase afterwards too.

The most significant piece of information in the minutes and the November IR is that the MPC members are **comfortable with markets now pricing in the first hike at the end of next year** (two quarters later than they had been expecting in August) and a more gradual rate normalisation process. Building this new path into their projections, they see more scope for hitting the target, even if there is greater slowdown among the emerging economies.

The figures that have come out since the November meeting are generally in line with the BoE outlook, although increases in wage costs and a fall in productivity could give rise to some more votes in favour of immediate rises in the coming months. Nonetheless, the dovish tone is likely to be kept up and the decision will continue to hinge on what other central banks do, especially the Fed. Assuming that lift-off in the United States takes place this month, we think that **the BoE is quite likely to begin raising rates in 2Q16** (one quarter after we were expecting in our August report), **although the uncertainty associated with the referendum, together with the Scottish elections in May and the greater confidence in the effectiveness of monetary policy, could lead to this rise being deferred until the second half of the year**.

Table 1
United Kingdom: macroeconomic forecasts
(% YoY save indication to the contrary)

	2010	2011	2012	2013	2014	2015	2016
GDP	**1,5**	**2,0**	**1,2**	**2,2**	**2,9**	**2,4**	**2,2**
Private consumption	0,0	0,1	1,8	1,9	2,6	2,9	2,3
Public consumption	0,2	0,1	1,8	0,5	1,9	1,6	0,2
Investment	5,0	2,0	1,5	2,6	7,5	4,0	5,1
Change in inventoires[1]	1,4	-0,6	0,5	0,9	0,0	-0,5	0,1
Domestic demand[1]	**2,4**	**0,4**	**1,9**	**2,7**	**3,3**	**2,3**	**2,5**
Exports	5,8	5,8	0,7	1,2	1,8	1,7	3,1
Imports	8,3	0,6	2,9	2,8	2,8	1,3	3,6
Net exports[1]	**-0,9**	**1,5**	**-0,7**	**-0,5**	**-0,4**	**0,1**	**-0,3**
Inflation	**3,3**	**4,5**	**2,8**	**2,6**	**1,5**	**0,1**	**1,3**
Employment[2]	0,2	0,5	1,1	1,2	2,3	1,7	1,0
Unemployment rate[2] (% Active population)	7,8	8,1	7,9	7,6	6,1	5,4	5,4
Public sector balance[2] (% GDP)	-9,7	-7,7	-8,3	-5,7	-5,7	-4,4	-3,0
Public sector debt[2] (% GDP)	76,6	81,8	85,3	86,2	88,2	88,3	88,0
Current account balance[2] (% GDP)	-2,8	-1,7	-3,3	-4,5	-5,1	-4,3	-3,9

1 Contribution to GDP growth
2 European Commission 2015 Autumn Forecasts
Forecast closing date: 10 November 2015
Source: European Commission and BBVA Research

United Kingdom

National accounts: moderation of growth in 2H15

GDP growth slowed by 0.2pp to 0.5% QoQ in 3Q15, as expected, weighed down by net exports and propped up by the robustness of domestic demand. For 4Q15, we expect growth to hold at around 0.5% QoQ

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

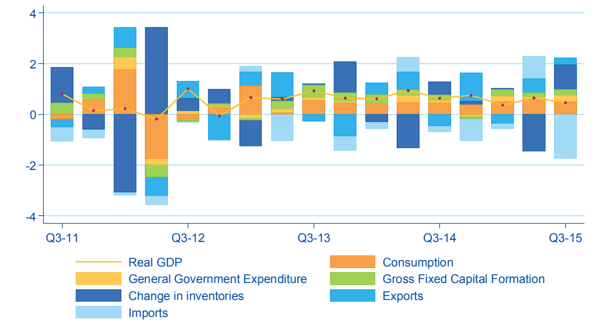
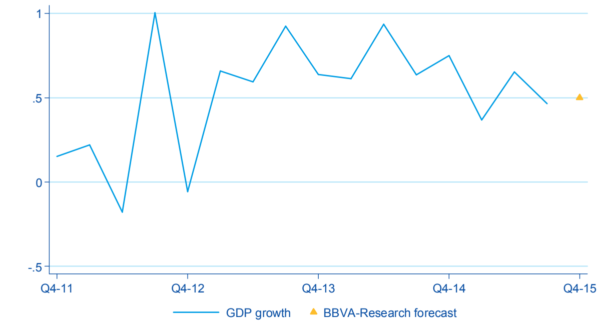


Figure 2
GDP growth (%QoQ) & forecasts*



Confidence: has fallen but is above the historical average

Mixed signs. Progressive decline in EC confidence indicators in recent months, while the PMIs are somewhat less optimistic. Nonetheless, both of them point to growth above the historical average, supported by domestic demand

Figure 3
PMI and GDP growth (%QoQ)*

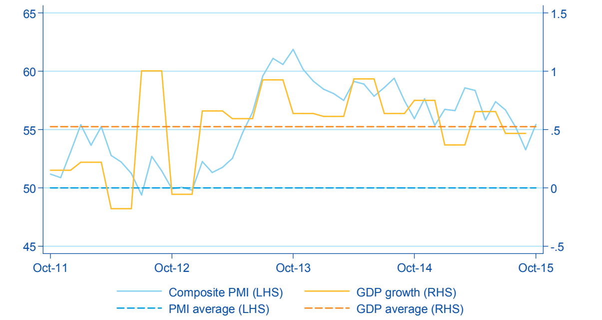
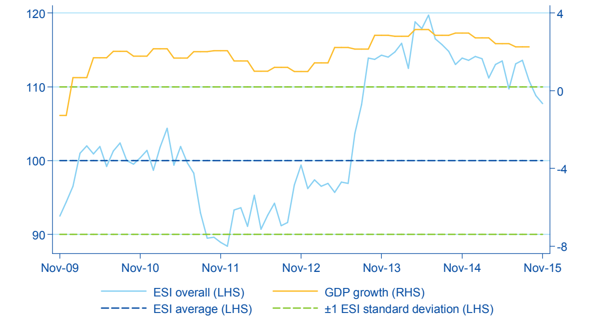


Figure 4
Confidence (ESI) and GDP growth (%YoY) **



Activity: more moderate consumption and investment

Industrial production stagnated in 3Q15, with the intermediate and capital goods components still failing to show clear signs of recovering. Retail sales were down in October, following the fine performance in 2Q15.

Figure 5
Industrial prod.(%YoY), manuf. new order and output PMI*

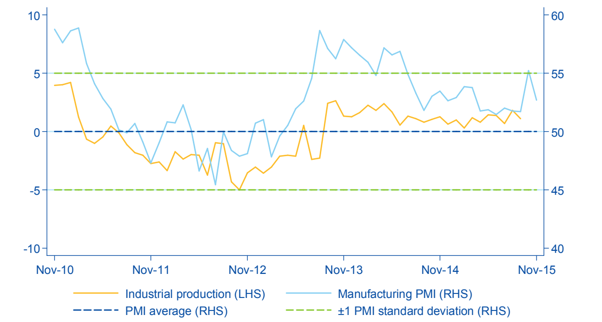
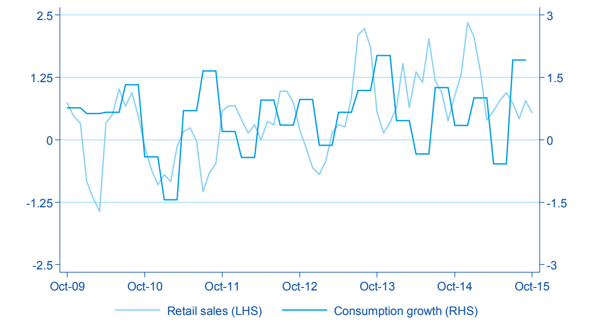


Figure 6
Retail trade (% 3m/3m) and consumption growth (%QoQ)*



*Source: Haver Analytics and BBVA Research

Foreign sector: exports ease up while imports pick up

Exports will continue to betray sterling strength and the deceleration among the emerging economies, while advancing at a slower pace than exports, thus sapping growth.

Figure 7
Trade balance (% of GDP)*

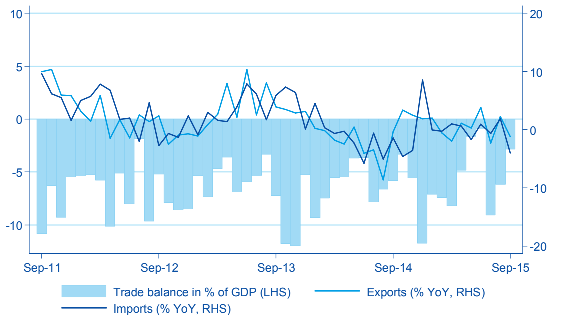
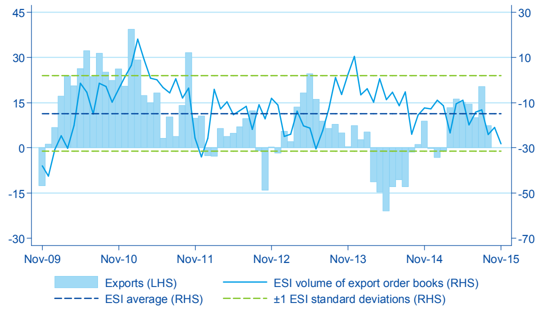


Figure 8
Export growth (%YoY) and volume of export order books**



Labour market: employment rises, productivity falls and wages are being contained

Certain signs of flagging were still apparent in the labour market in 3Q15, while rising wages have been contained.

Figure 9
Unemployment rate (%) and employment expectations*

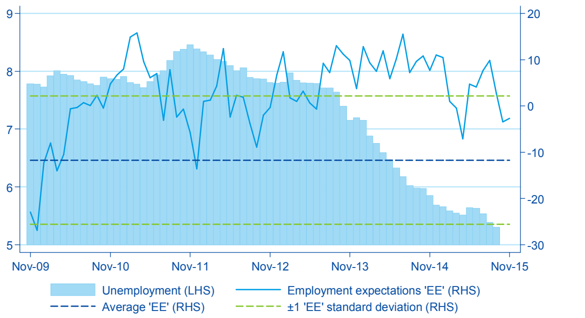
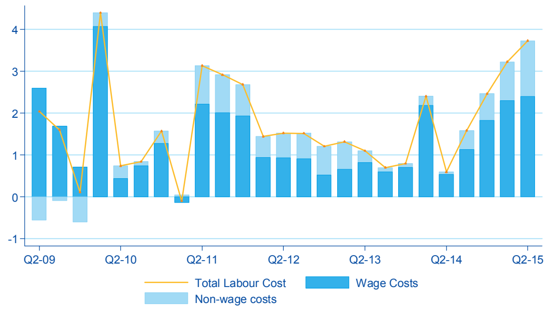


Figure 10
Labour cost in the business sector (%YoY)*



Prices: inflation below the target rate until 2017

Our forecasts indicate that inflation could rise to around 1% YoY in 1Q16, as a result of the energy and food price base effect, but it will remain clearly below the target rate in 2016.

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

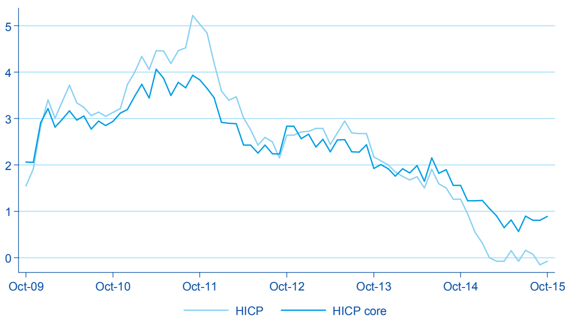
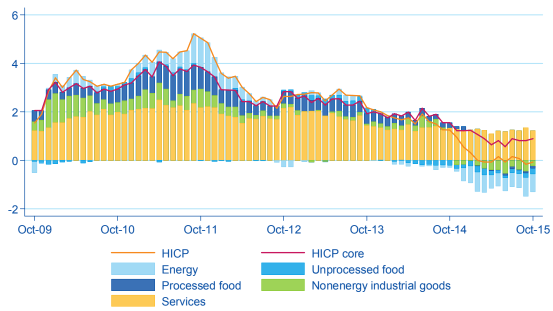


Figure 12
Inflation by components (contribution in %)*



* Source: Haver Analytics and BBVA Research

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