

August
2016



Eurozone
Short-term Indicators and
Updated Forecasts

Economic Outlook

- **Economic recovery continues at a moderate pace** in 2Q16 (0.3% QoQ), once the temporary effects that boosted internal demand earlier this year disappeared, while net exports improved
- Activity data at the end of 2Q16 suggest less optimistic signals than **confidence surveys**, which even so remain **stable in the early stages after Brexit**
- **Brexit will weigh on the recovery of the eurozone as a whole** in the forecast horizon. **The impact will be limited**, and will be transmitted above all through the trade channel and its impact on confidence, which will put a brake on consumption and investment
- The **ECB** is **ready to take further stimulus measures** if needed; an extension until September 2017 and a fine-tuning of the QE programme are not to be ruled out
- **Updated forecasts: we maintain our growth projection** for the eurozone **at 1.6% in 2016**, but due to Brexit and lower tailwinds, **it is revised downwards to 1.5% in 2017**. The revision affects all the main eurozone countries
- **Risks remain tilted to the downside and are especially political**, beyond those related to global growth

Index

Section 1

Economic development: a moderate recovery continues in the first stages after Brexit

Section 2

Updated forecasts: downward revision of GDP growth in 2017, due to the impact of Brexit and lower tailwinds

Section 3

Risks: tilted to the downside, especially the political ones



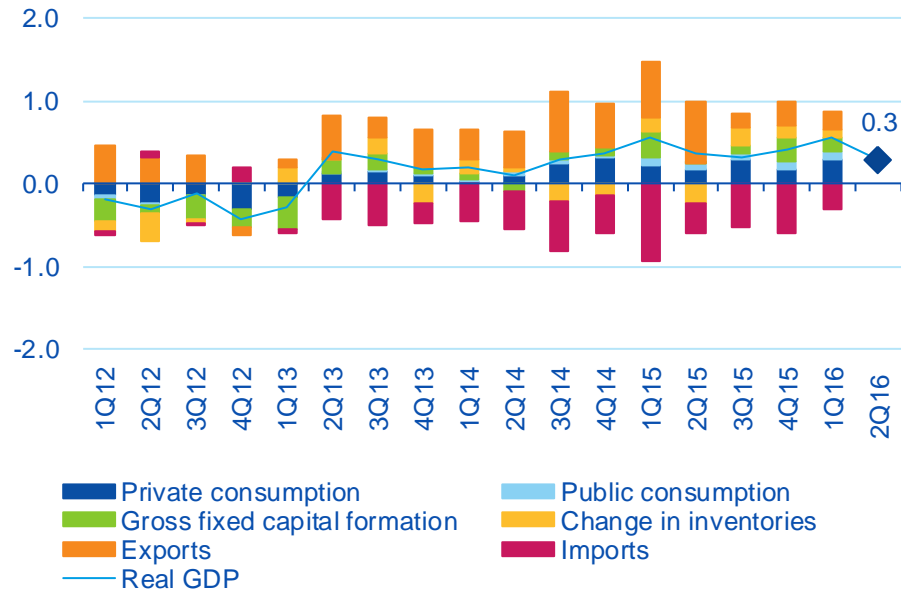
Section 1

Economic development

GDP growth in the eurozone slowed down in 2Q16 to the moderate pace of the last two years

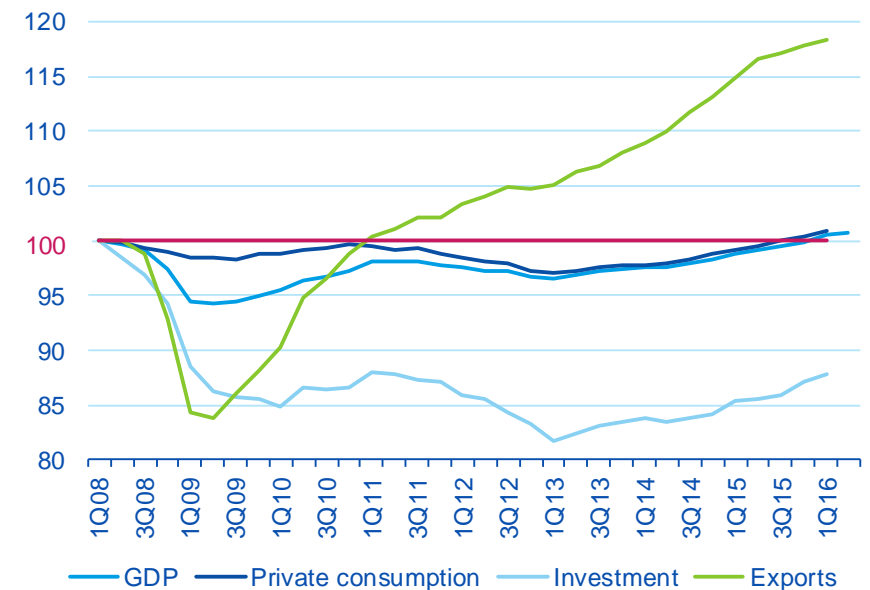
- **GDP growth moderated to 0.3% QoQ in the second quarter** due to the reversion of some of the temporary factors which supported the strong upturn in earlier this year (0.6% QoQ), especially in France and Germany
- Available data point to the fact that the slower growth was due to the **moderation of internal demand, partly offset by the improvement in net exports**

GDP (% QoQ), contribution by components (pp) and MICA BBVA forecast



Source: Eurostat and BBVA Research

GDP and its components (1Q08=100)

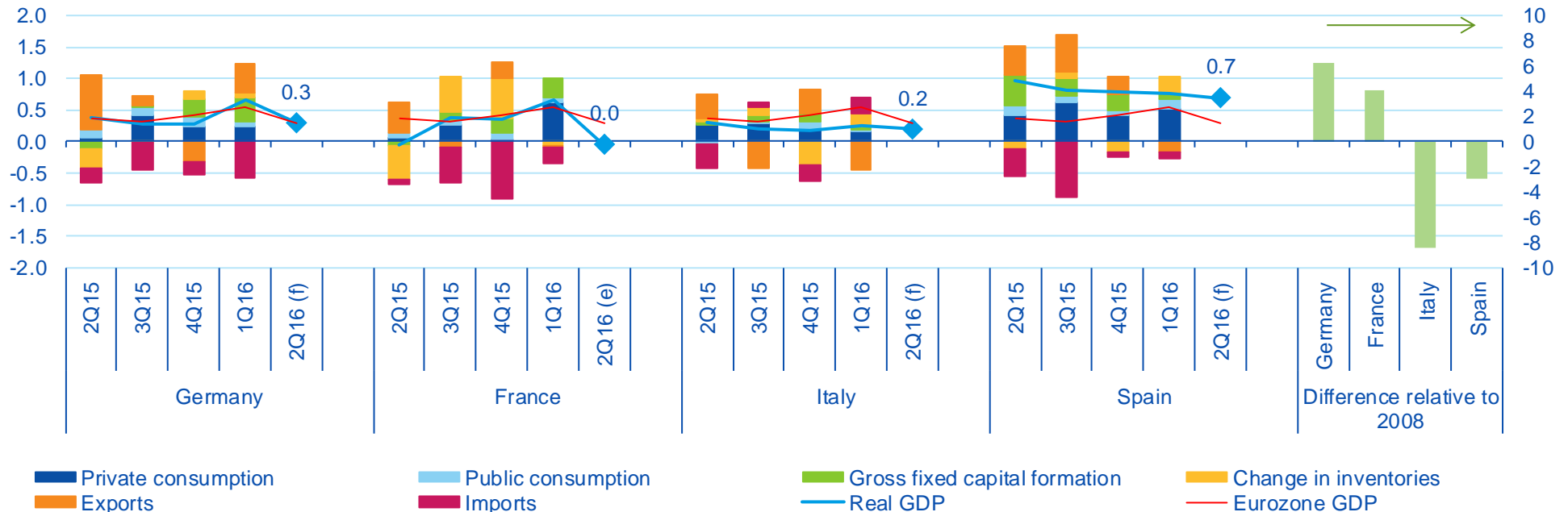


Source: Eurostat and BBVA Research

This slowdown was widespread across large countries

- GDP was flat in **France** in 2Q16 after the strong moderation in private consumption, due to temporal factors, and the fall in investment. In **Germany** growth slows down because of more moderate growth in domestic demand
- In **Italy and Spain** growth remains relatively stable, with the former still growing somewhat below the growth rate in the whole of the eurozone, while Spain maintains a strong positive differential

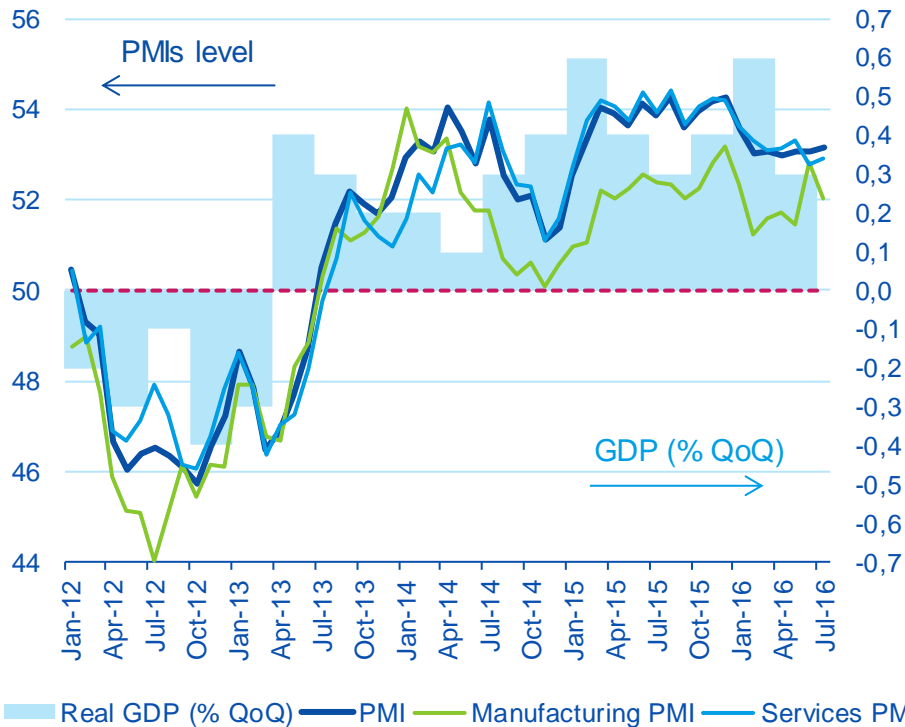
GDP (% QoQ), contribution by component (pp) and forecasts



PMIs stable in 2Q16 and increasing slightly in July, in spite of Brexit uncertainty...

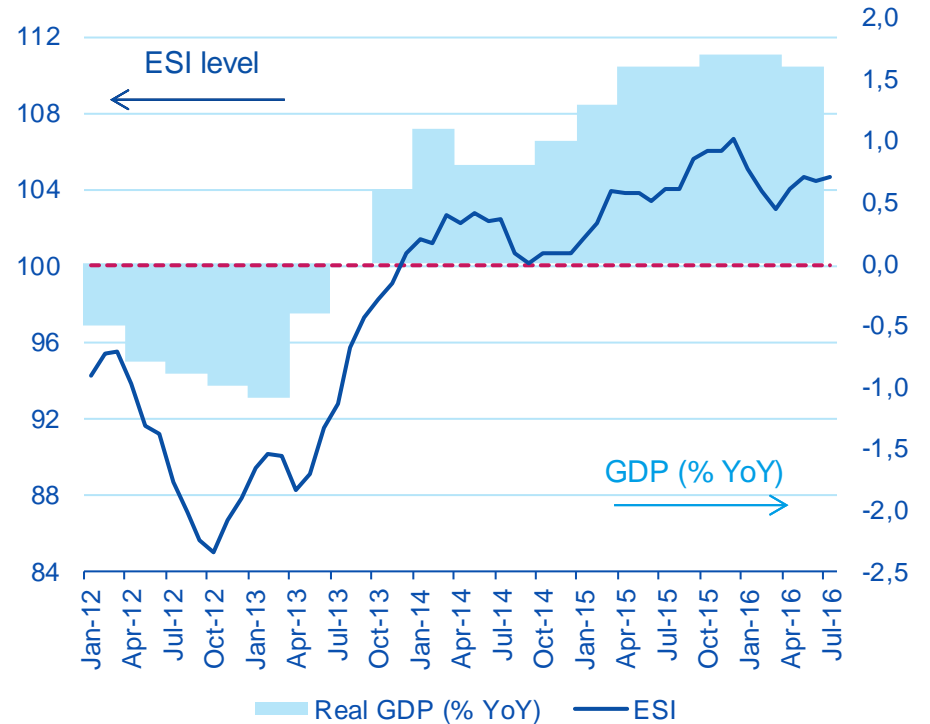
The performance of PMIs in July can be explained by the increase of new orders in the services sector, thanks to which employment has increased, offset by the fall in the manufacturing index

PMI and GDP (% QoQ)



Source: Eurostat and BBVA Research

ESI and GDP (% YoY)

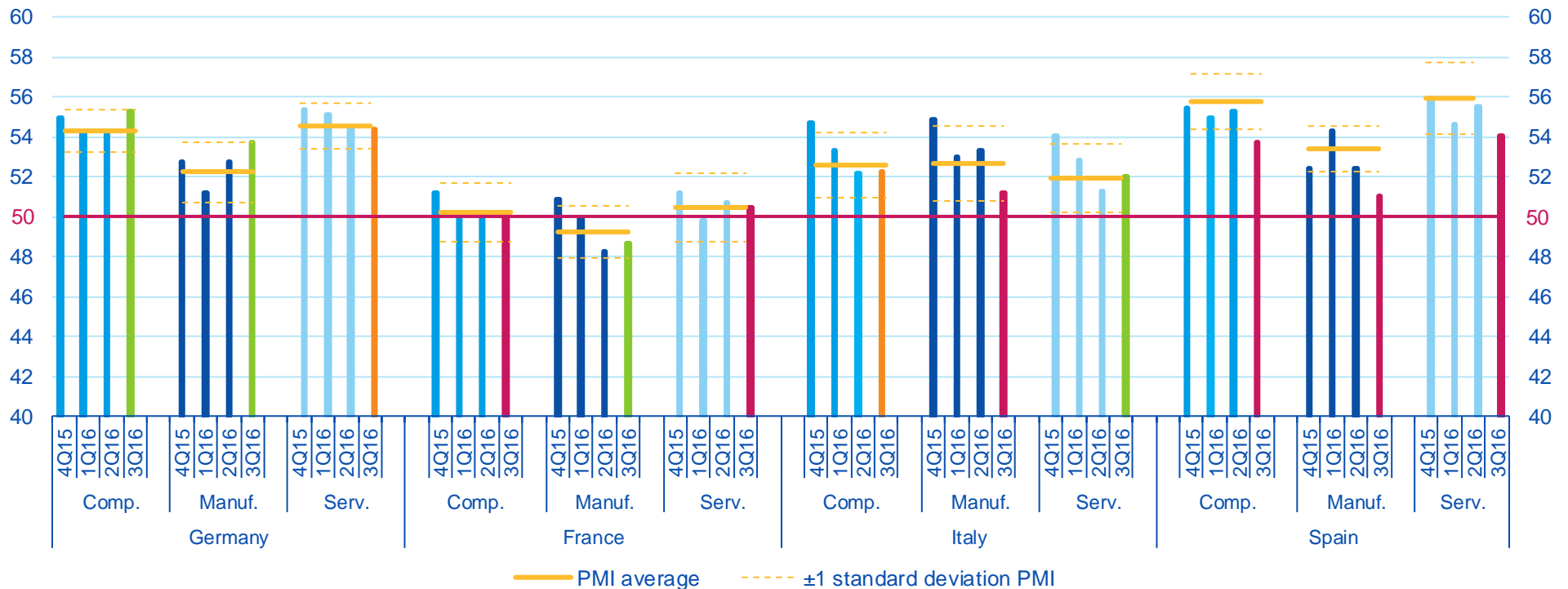


Source: Eurostat and BBVA Research

... driven by Germany

National PMIs showed that growth was mainly driven by higher expansion in Germany. The index decreased in Italy and Spain in July, while France moves out of contraction territory

PMI (level)

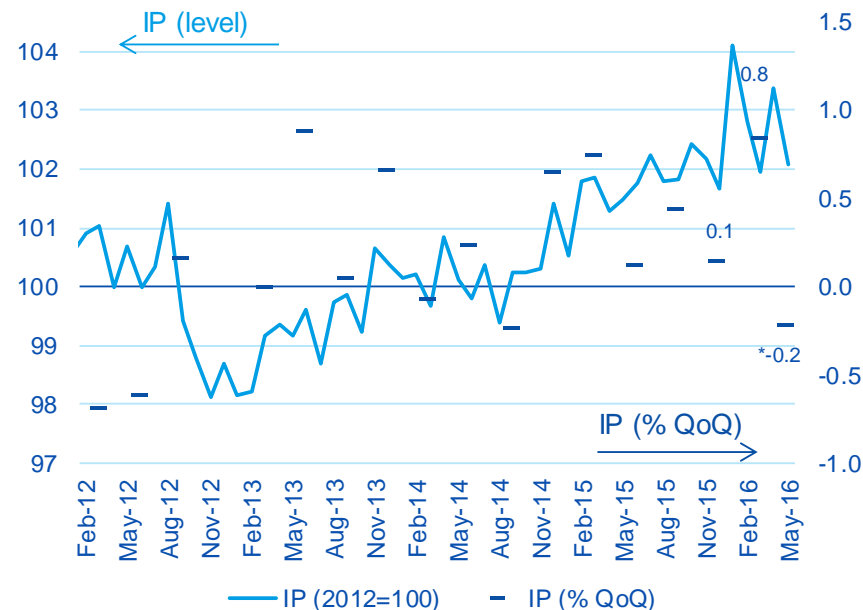


* 3Q16 calculated using only data for July
Source: Eurostat and BBVA Research

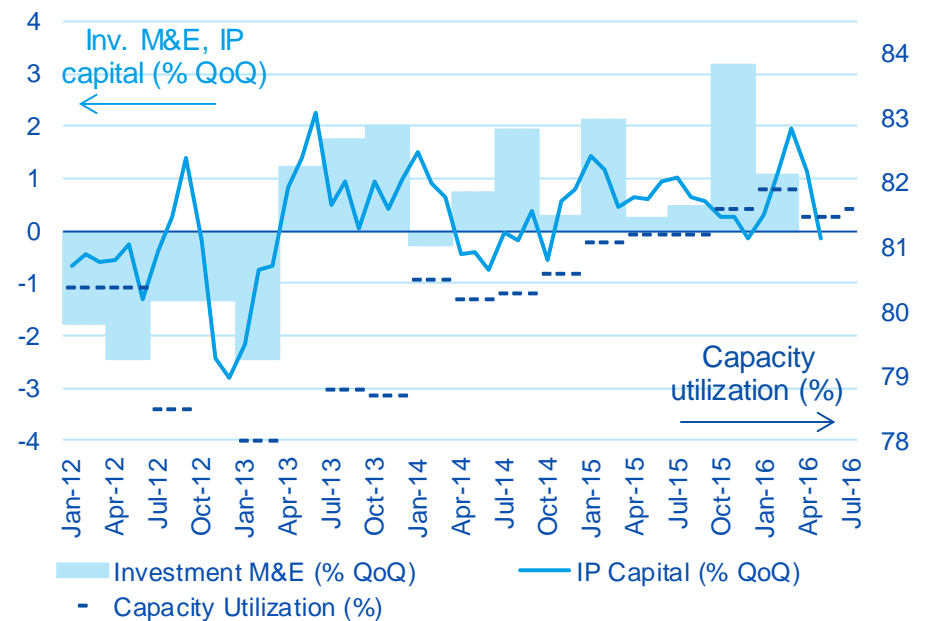
Industrial production declined in May, in a period of high volatility

- Industrial production declined in May by 1.1% MoM after increasing by 1.4% in April. The fall was widespread across sectors, especially in the production of consumer durables and capital goods
- The gradual increase in capacity utilization during the last year and a half, together with better prospects for external demand, point to the consolidation of the recovery in equipment and machinery investment

Industrial production (% QoQ)



IP Capital (% QoQ), Investment in machinery and equipment (% QoQ) and utilization capacity (%)



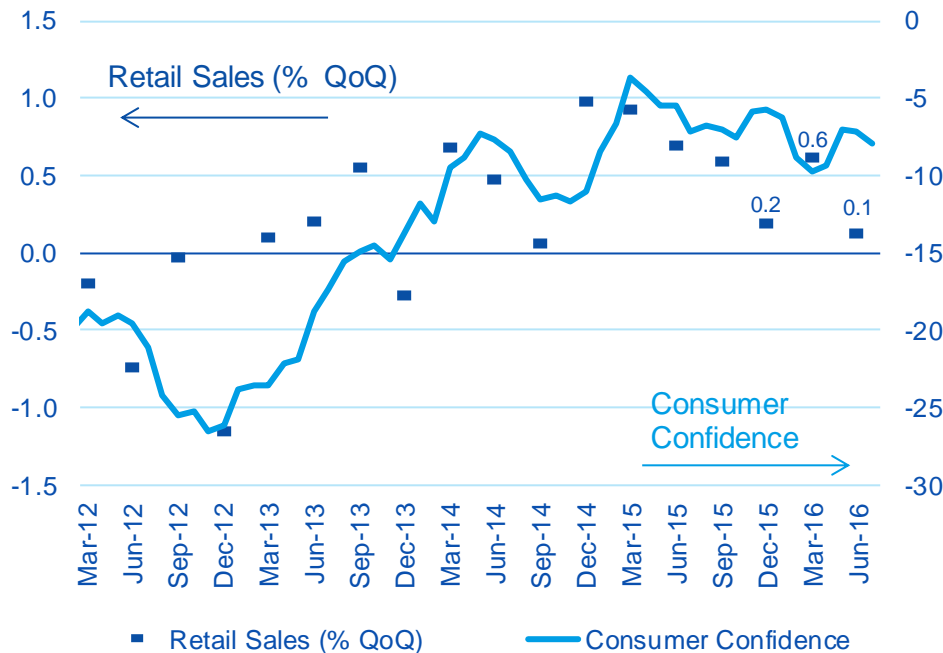
* April and May compared to previous 3 months
Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

Retail sales growth moderated in 2Q16, after the temporary upturn of 1Q16

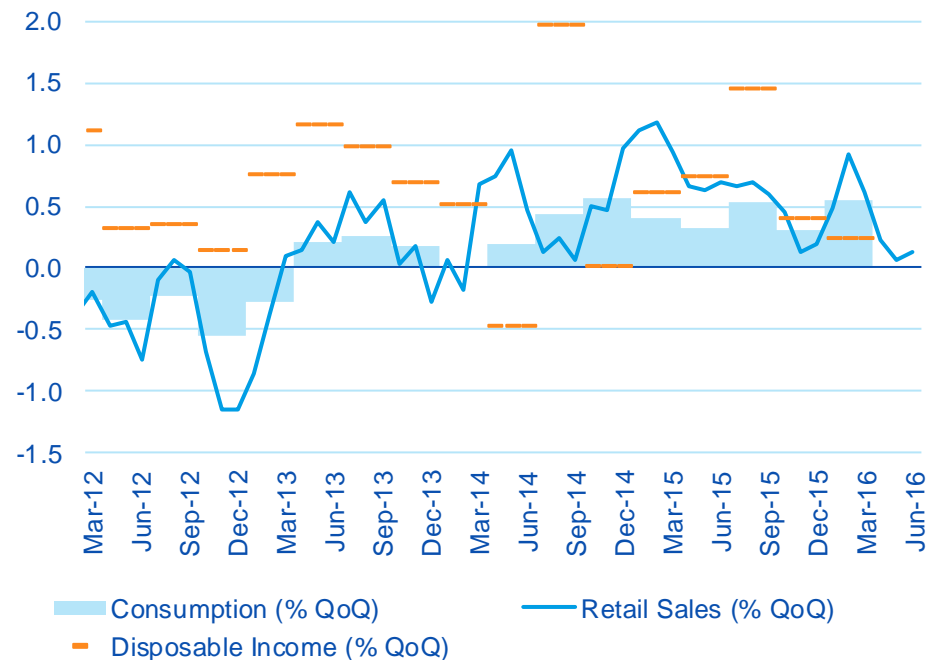
Retail sales growth moderated significantly in 2Q16 (0.1% QoQ) after a temporary upturn in the first quarter (0.6% QoQ), so a slowdown in private consumption is projected for the second quarter

Retail sales (% QoQ) and consumer confidence



Source: Eurostat and BBVA Research

Retail sales, consumption and disposable income (% QoQ)

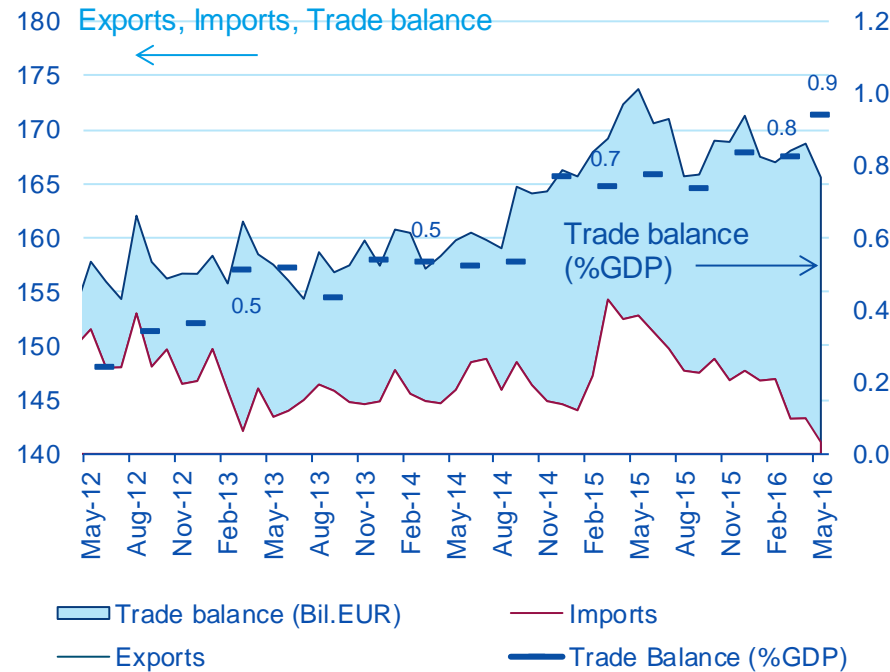


Source: Eurostat and BBVA Research

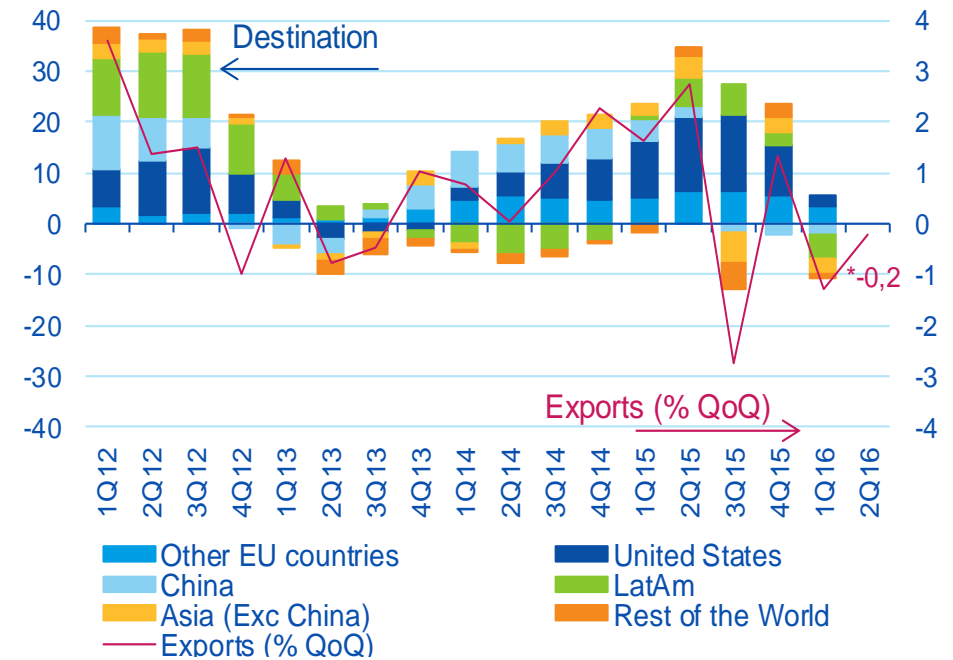
Exports stand in 2Q16

Exports decrease in the second quarter until May (-0.2% QoQ), less than imports (-2.4%), resulting in an increase in the trade balance surplus

Trade balance (% GDP)



Exports by destination (% QoQ)



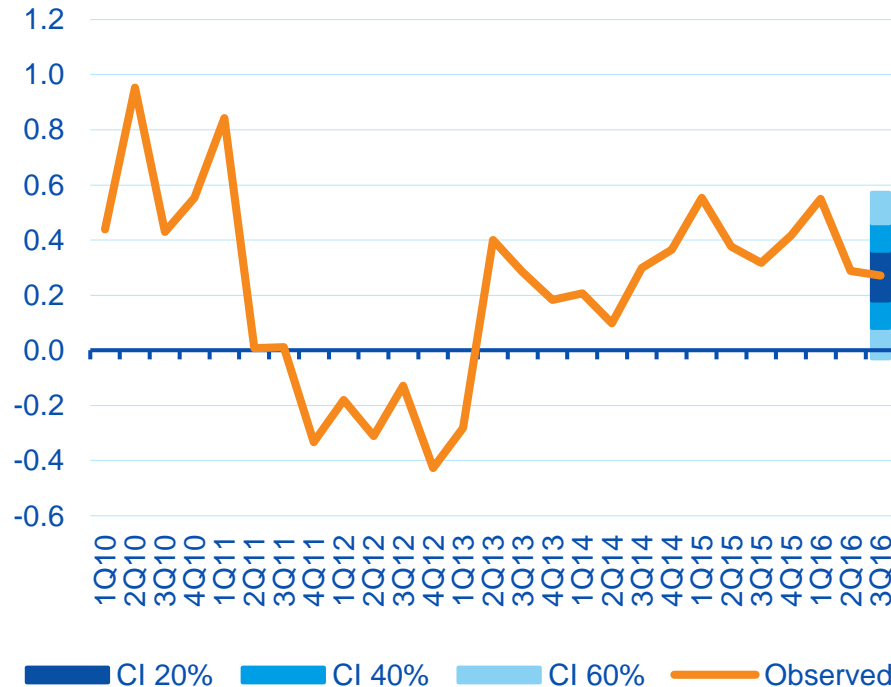


Section 2

Updated forecasts

Moderate growth is expected to continue in 3Q16

Eurozone: GDP growth and projection based on MICA-BBVA model (% QoQ)

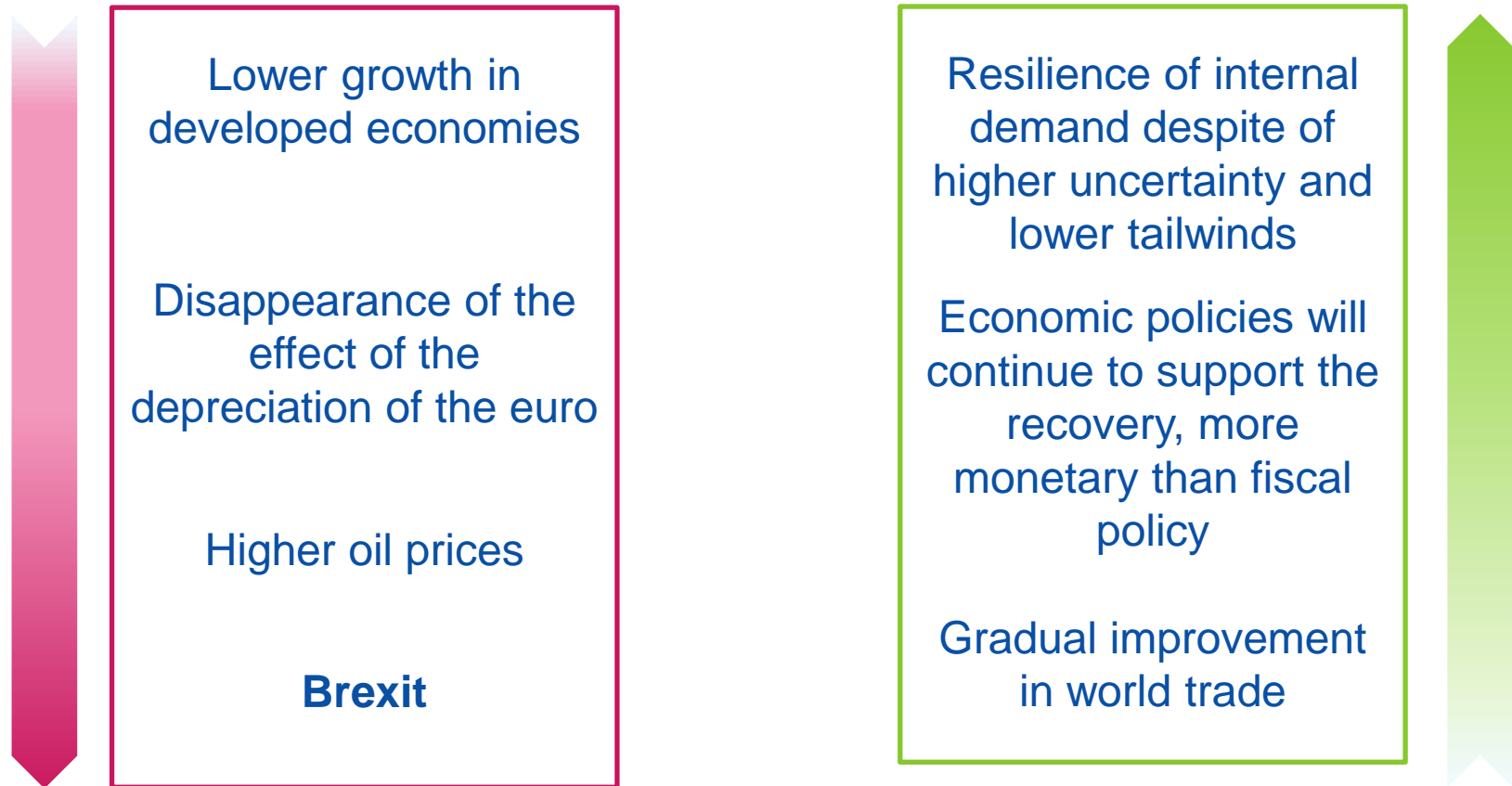


MICA-BBVA: 0.3% QoQ in 3Q16

Confidence resilience after Brexit, but risks tilted to the downside

After strong figures in April, activity data (industrial production and retail sales) showed less optimistic signs in May and June

Lower tailwinds are added to the materialisation of the risk of Brexit

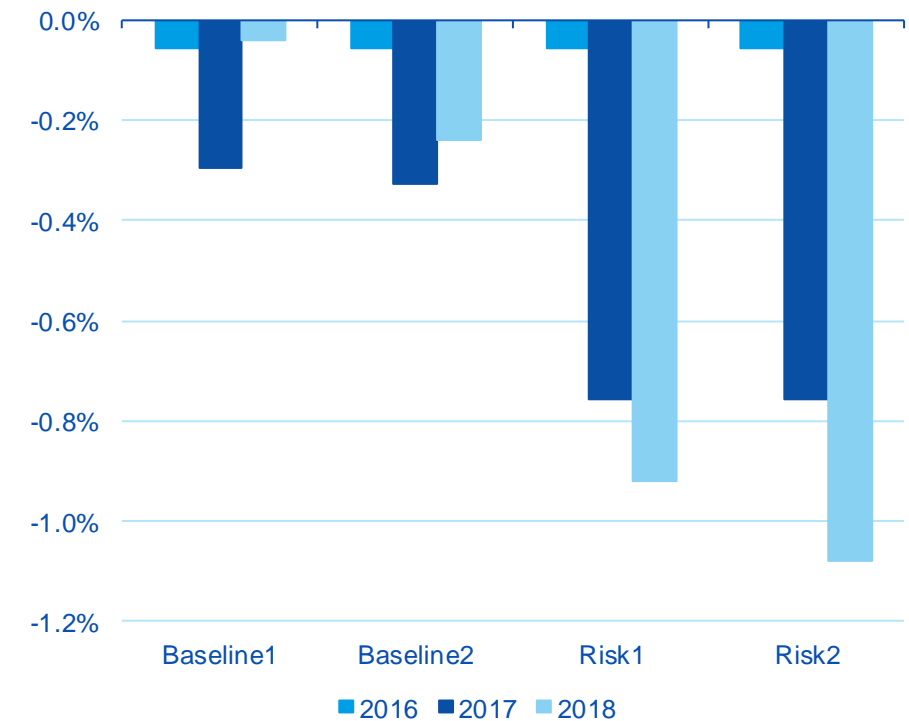


Brexit could drain between 0.4pp and 0.6pp from GDP growth in 2016-18

Eurozone: BBVA Research Financial Stress Index (normalized Index)

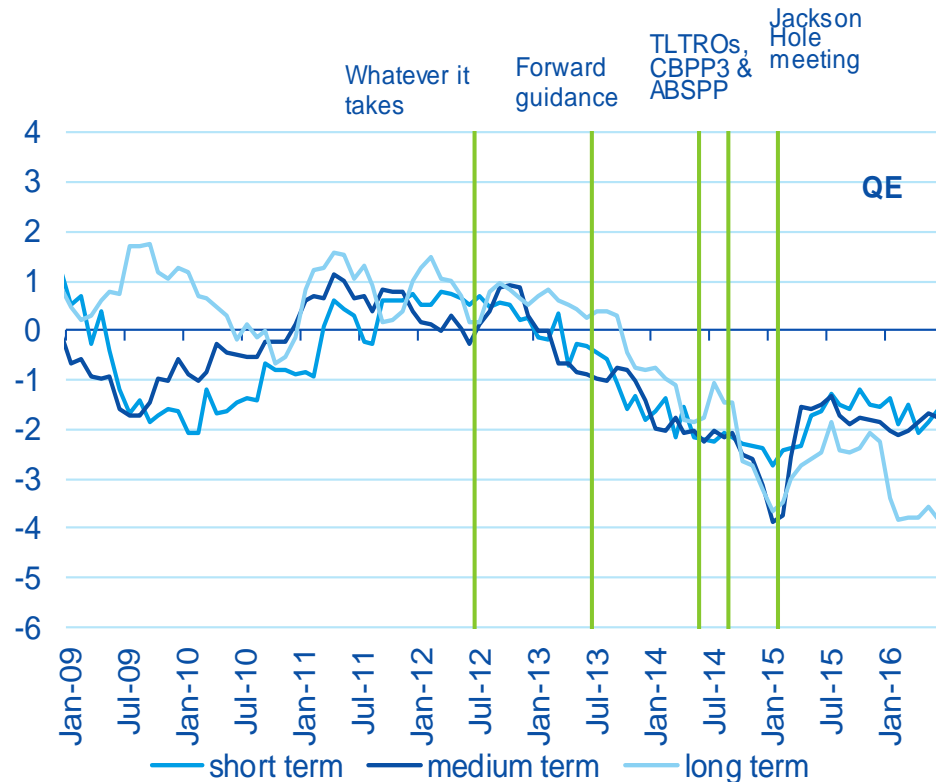


Eurozone: Impact of Brexit on GDP (%)



ECB: increasing pressure for additional measures due to the risk balance

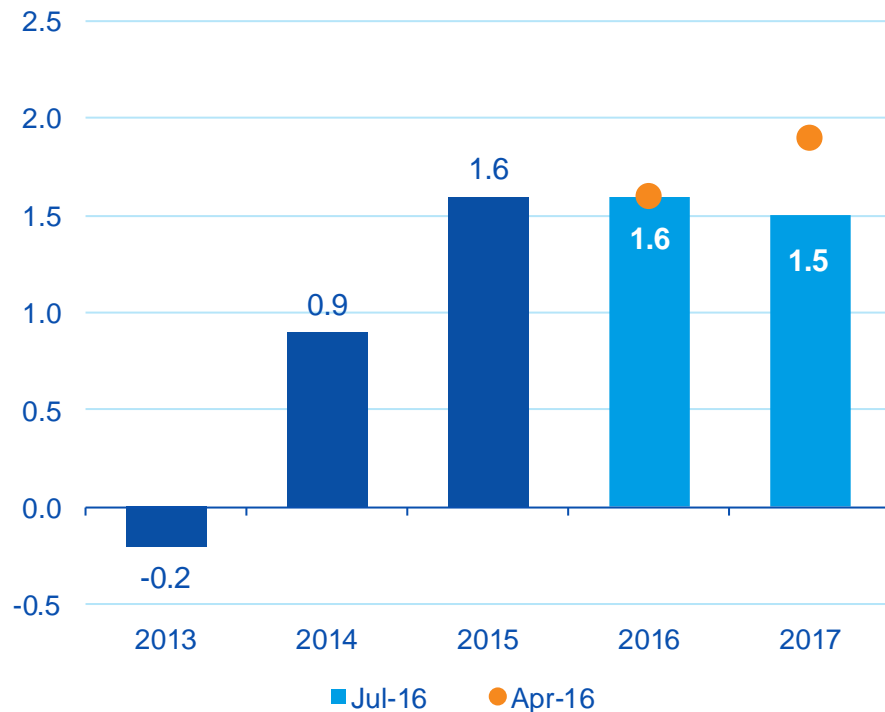
BBVA EZ Inflation Monitor Index



Extension and fine-tuning of QE	Highly likely
Cut in depo rate	Unlikely for now
Increase in the amount of QE	
Helicopter money is out of the question	

Downward GDP growth revision: more moderate recovery

Eurozone: GDP growth (%)



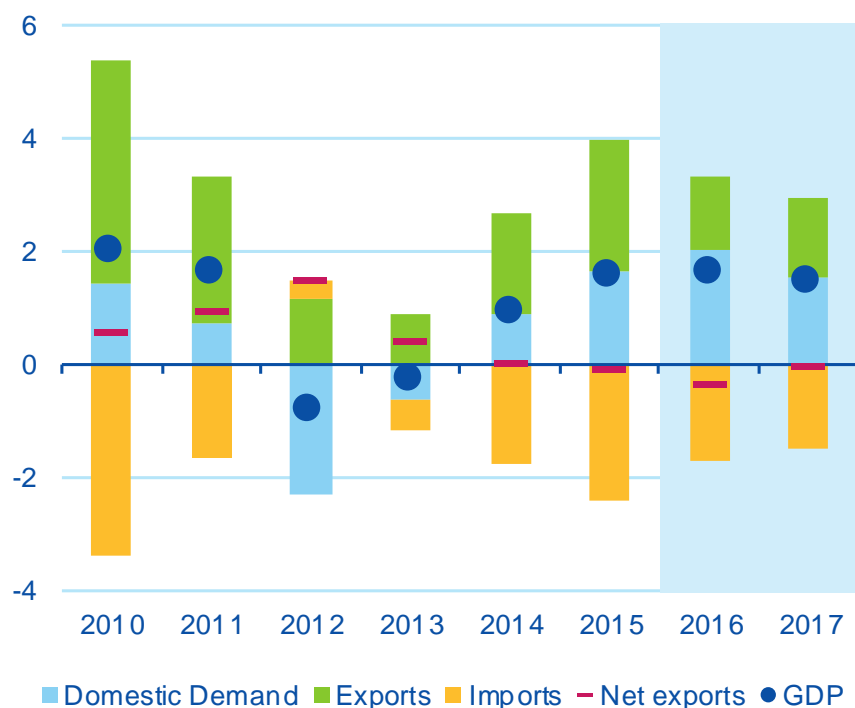
Better-than-expected incoming data, especially on the internal demand side

Brexit will weigh on forecasts despite monetary policy support (and fiscal, but to a lesser extent)

ECB's further measures: an extension and fine-tuning of QE are the more likely options

Higher uncertainty will put a brake on internal demand

Eurozone: contribution to annual GDP growth (pp)



	2014	2015	2016 (f)	2017 (f)
Activity				
Real GDP (% QoQ)	0.9	1.6	1.6	1.5
Private consumption	0.8	1.7	1.7	1.4
Public consumption	0.8	1.3	1.5	1.1
Investment	1.3	2.7	3.0	2.7
Internal demand (contr. pp)	0.9	1.7	2.0	1.5
Exports	4.1	5.1	2.9	3.0
Imports	4.5	5.9	4.1	3.4
Net exports (contr. %)	0.0	-0.1	-0.4	-0.1
Current account (% GDP)	2.5	3.2	3.2	3.0
Budget balance (% GDP)	-2.6	-2.1	-2.0	-1.9
HICP, % average	0.4	0.0	0.2	1.4

Germany: strong consumption, but lower exports and investment after Brexit

	2014	2015	2016 (f)	2017 (f)
Activity				
Real GDP (% QoQ)	1.6	1.4	1.4	1.5
Private consumption	1.0	2.0	1.6	1.6
Public consumption	1.7	2.5	2.4	1.9
Investment	3.5	1.6	3.0	2.5
Internal demand (cont. pp)	1.2	1.3	1.9	1.8
Exports	3.9	4.8	2.1	2.7
Imports	3.7	5.4	3.6	3.8
Net exports (cont. pp)	0.4	0.1	-0.5	-0.3
Current account (% GDP)	7.3	8.5	8.4	7.4
Budget balance (% GDP)	0.3	0.7	0.2	0.0
HICP, % average	0.8	0.1	0.1	1.4

Higher uncertainty will weigh on consumption, somewhat weaker than expected earlier this year...

... and especially on investment from the second half of 2016 and in 2017

Lower exports after Brexit will put somewhat more downward pressure on GDP growth this year and the following

France: weaker internal demand due to the worsening of domestic factors and uncertainty in Europe

	2014	2015	2016 (f)	2017 (f)
Activity				
Real GDP (% QoQ)	0.7	1.2	1.5	1.4
Private consumption	0.7	1.5	1.7	1.5
Public consumption	1.2	1.4	1.6	1.2
Investment	-0.4	0.9	3.2	2.2
Internal demand (cont. pp)	1.1	1.5	2.1	1.6
Exports	3.4	6.0	2.5	3.4
Imports	4.8	6.4	4.0	3.7
Net exports (cont. pp)	-0.5	-0.3	-0.5	-0.2
Current account (% GDP)	-0.9	0.0	-0.5	-0.2
Budget balance (% GDP)	-4.0	-3.5	-3.4	-3.2
HICP, % average	0.6	0.1	0.2	1.4

The deterioration of domestic factors, especially the worsening of the labour market, will be reflected in a moderation of private consumption

In a difficult political environment which also affects confidence and investment decisions...

... which will be intensified after the Brexit shock

Italy: political issues and those of the banking sector are added to uncertainty in Europe

	2014	2015	2016 (f)	2017 (f)
Activity				
Real GDP (% QoQ)	-0.3	0.6	1.0	1.1
Private consumption	0.6	0.9	1.2	1.0
Public consumption	-1.0	-0.7	0.8	0.3
Investment	-3.3	0.6	1.8	2.0
Internal demand (cont. pp)	-0.3	1.0	1.2	0.9
Exports	2.9	4.1	0.5	2.7
Imports	3.0	5.8	1.2	2.3
Net exports (cont. pp)	0.0	-0.3	-0.2	0.2
Current account (% GDP)	1.8	2.2	2.7	2.6
Budget balance (% GDP)	-3.0	-2.6	-2.5	-2.1
HICP, % average	0.2	0.1	0.0	1.3

Growth continues supported by public consumption, but the investment and exports data earlier this year suggest that the weak recovery is failing to gain traction

Political crisis and problems in the banking sector will weigh even more on domestic demand

It is difficult to see the external sector taking over

Spain: an improved forecast for 2016 GDP growth, and a downward revision in 2017

	2014	2015	2016 (f)	2017 (f)
Activity				
Real GDP (% QoQ)	1.4	3.2	3.1	2.3
Private consumption	1.2	3.1	3.3	1.9
Public consumption	0.0	2.7	2.5	1.8
Investment	3.5	6.4	3.9	3.5
Internal demand (cont. pp)	1.6	3.7	3.4	2.2
Exports	5.1	5.4	3.8	4.4
Imports	6.4	7.5	4.9	4.5
Net exports (cont. pp)	-0.2	-0.5	-0.2	0.1
Current account (% GDP)	1.0	1.4	1.5	1.9
Budget balance (% GDP)	-5.8	-5.0	-4.2	-3.6
HICP, % average	-0.2	-0.5	-0.3	1.7

Incoming data confirm an upward bias to GDP growth forecasts in 2016:

- Domestic demand explains the recovery
- M&E growth is a resilient component

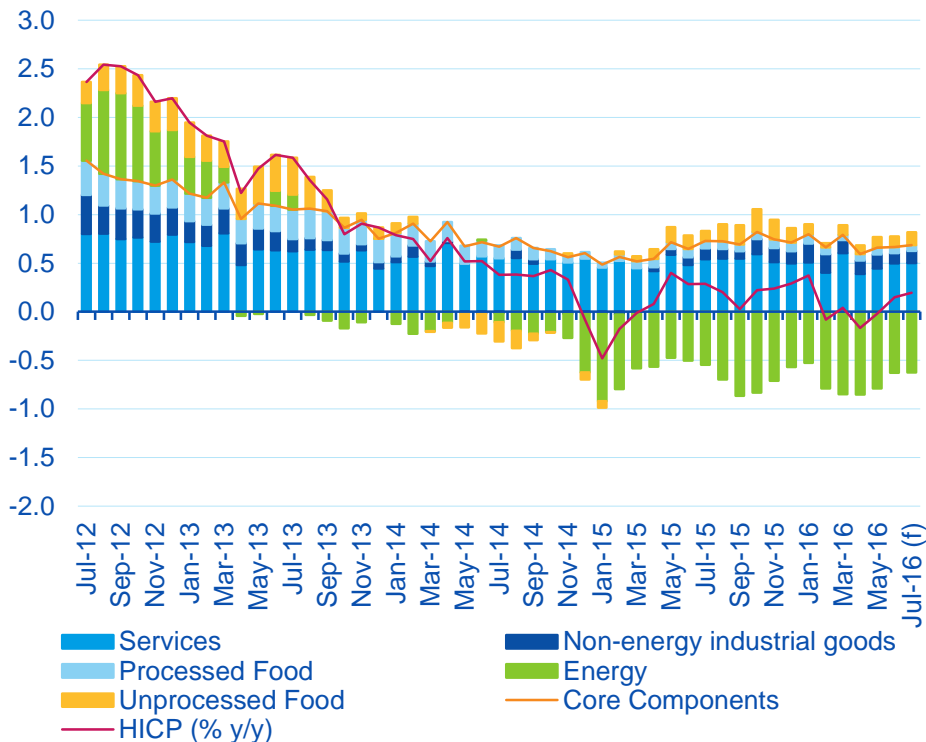
Tailwinds, exchange rate and oil price, still support growth, but less so. Exports remain resilient, but EMU demand will slow

Downward risks: strong fiscal consolidation and Brexit

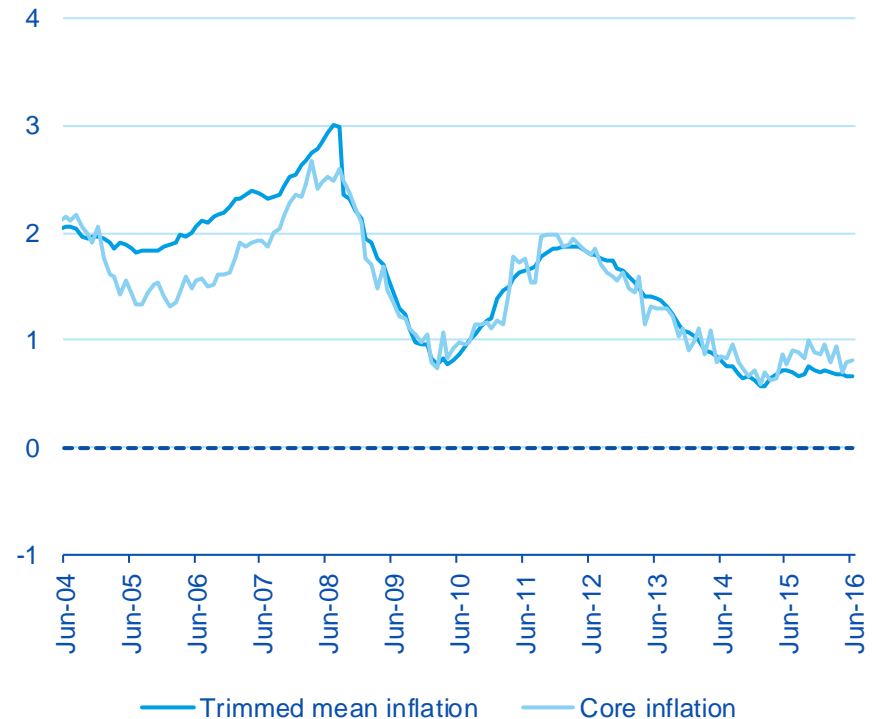
Political risks continue

Subdued but stable core inflation since mid 2013. Headline inflation very low due to oil prices

Eurozone: Inflation (% YoY) and contribution of components (% pp)

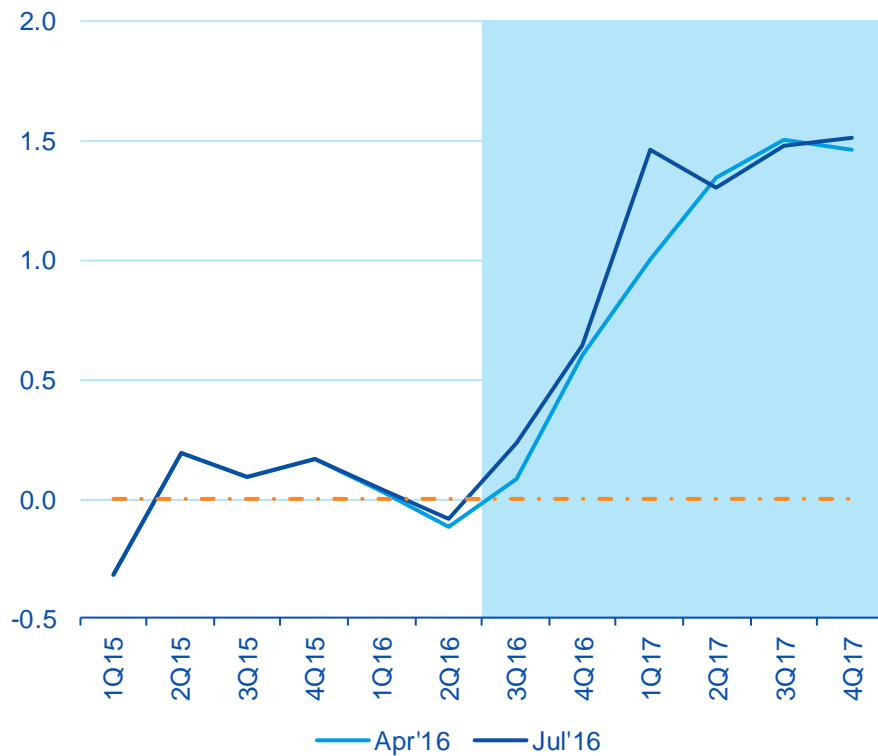


Eurozone: inflation (% YoY)

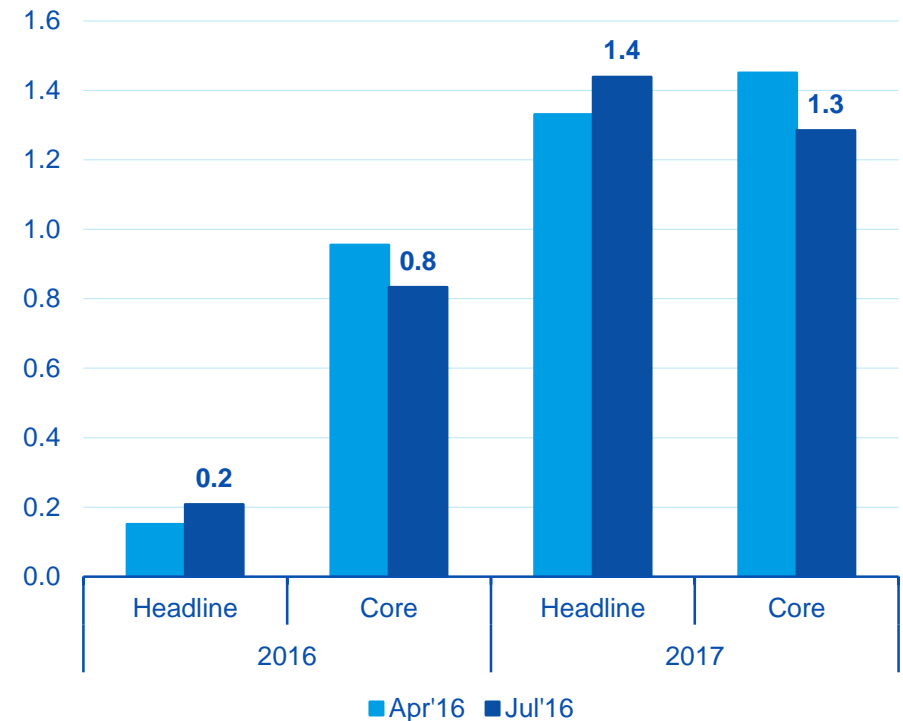


Higher oil prices should drive inflation up by year end and early 2017, but below 2%

Eurozone: inflation forecasts (% YoY)



Eurozone: inflation forecasts (% annual)

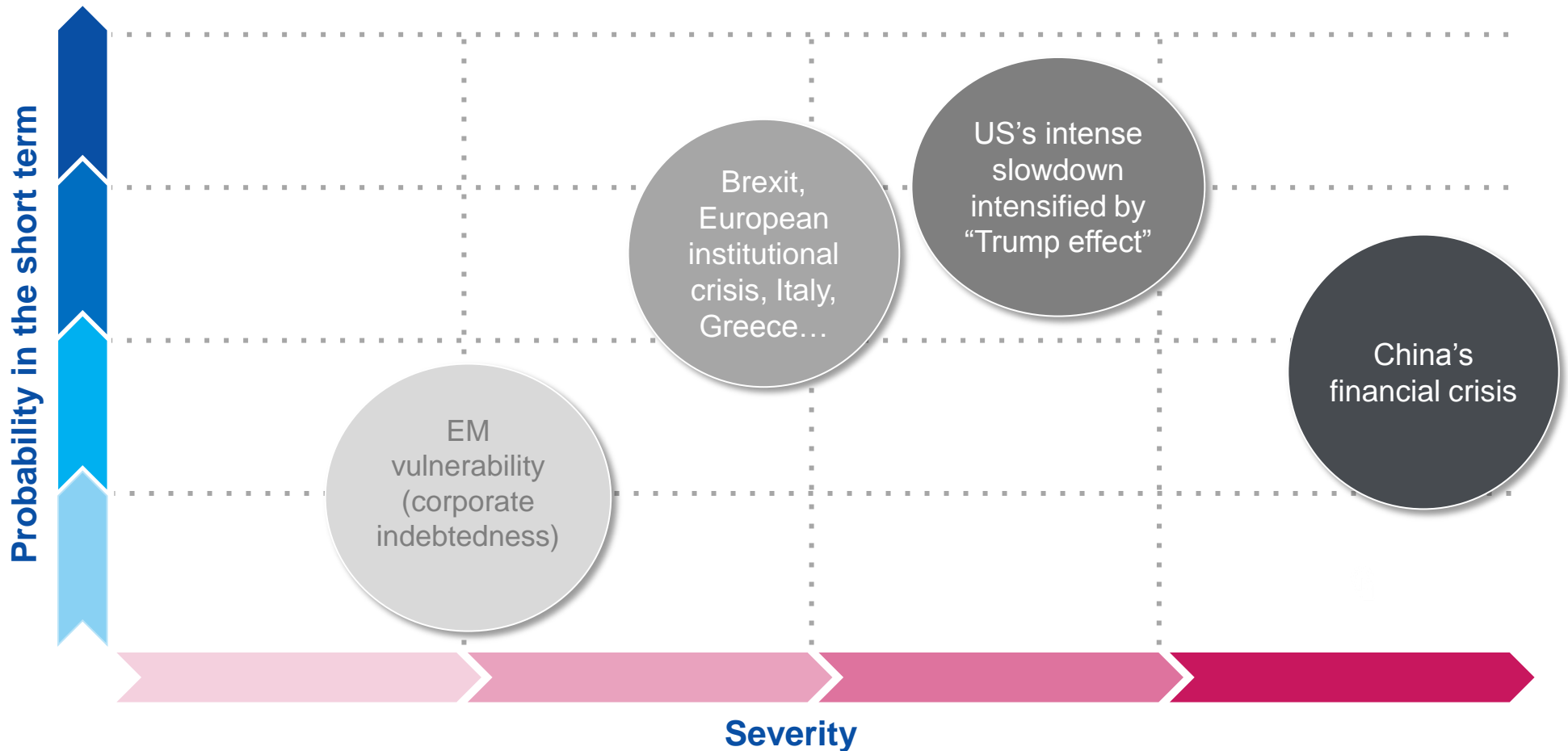




Section 3

Risks

Global risks: rotation towards DM; risk of slowdown in the US and risks about Europe have risen



Europe: increasing risks, especially political and geopolitical issues

Risks after Brexit

Potential political contagion from Brexit

- **Italy is the country to watch.** Constitutional referendum: if Renzi loses, he might step down (as promised) and early elections may bring an anti-euro party
- **Other elections:** the Netherlands, France and Germany over 2017, with radical parties on the up

Negotiation strategy UK-EU

- **Equilibrium between avoiding contagion and punishing the UK too much**
- **France and the periphery** interested in a harsh position
- **Germany** in principle more ready to cede ground

Prospects of pro-integration reaction

- Germany more ready to **reinforce the EU rather than the EZ**
- EU ready for more **integration in less controversial issues:** security, immigration, external borders. These are EU issues, not EZ ones
- **Germany refuses to mutualize debt** before legacy problems are solved
- **If the situation deteriorates significantly,** there would be advances towards more integration in the eurozone (common deposit guarantee, common treasury, fiscal union)

Other risks in Europe

- **Italy:** problems in the banking sector
- **Greece:** unresolved problems, although lower risks
- **Refugee crisis intensified if relations with Turkey deteriorate**

Disclaimer

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.