BBVA | RESEARCH

Eurozone

Economic Watch

FEBRUARY 2017

Eurozone: A slight upward revision to our GDP growth projections

- **The recovery proceeded at a steady and solid pace in 4Q16**, resulting in an average annual GDP growth of 1.7% in 2016. **Hard data up to December** along with national figures point to **consumption as the main driver of growth**, while **investment could have increased markedly supported by increasing exports but also construction** (Germany).
- **Improving confidence** across sectors and countries **at the start of 2017** suggest that the **recovery could be gaining momentum in 1Q17** driven by increasing foreign demand and the depreciation of the euro at the end of 2016. **Nonetheless, soft data have provided an upbeat outlook** as compared to hard indicators over the last half year, while consumer confidence declined in February.
- Our **MICA-BBVA model estimates quarterly GDP growth in the eurozone to reach 0.5% QoQ in 1Q17**, after growth of 0.4% in 2H16.
- **For 2017 and 2018 growth is expected** at 1.6%, implying a marginal upward revision, supported by very relaxed monetary conditions, a weak euro, improving global trade, and non-restrictive fiscal policies.
- **Risks remain tilted to the downside and are mostly political**, both at national and Europe-wide level, but derive also from financial sector fragilities.
- **Inflation should remain below the ECB target in 2017-18**, although it will reach a peak at the start of this year close to 2% owing to base effects and energy price increases, before reverting to somewhat lower levels (annual average inflation expected at 1.6% in 2017 and 2018). Core inflation remains stable below 1% and is expected to increase gradually to around 1.5% by the end of the forecast horizon.

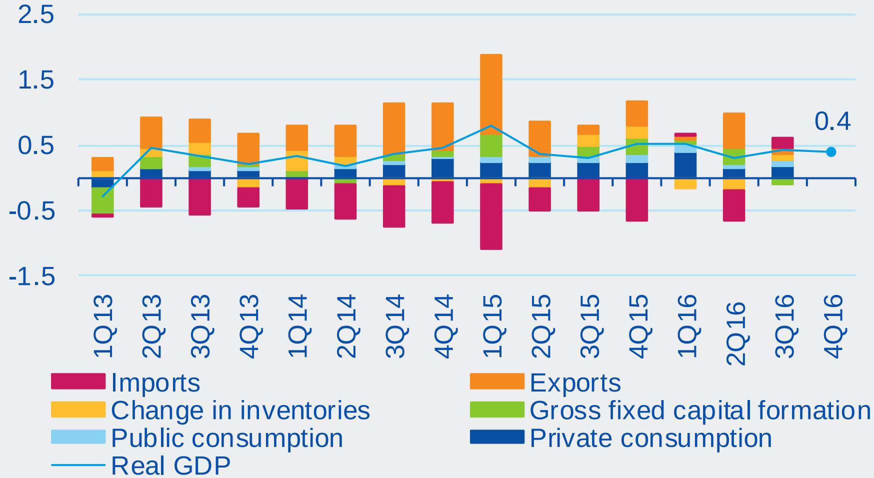
RECENT DEVELOPMENT: POSITIVE SIGNS HAVE YET TO BE CONFIRMED

FEBRUARY 2017

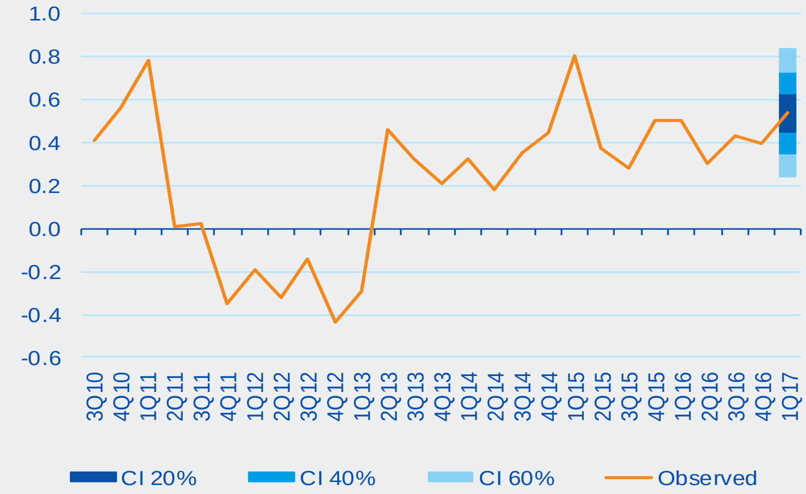
ECONOMIC DEVELOPMENTS

GDP growth stabilized at 0.4% QoQ in 4Q16 while incoming data suggest a further gain of momentum in early 2017

GDP, CONTRIBUTION BY COMPONENTS
(%QoQ, pp)



GDP AND MICA FORECASTS
(%QoQ)



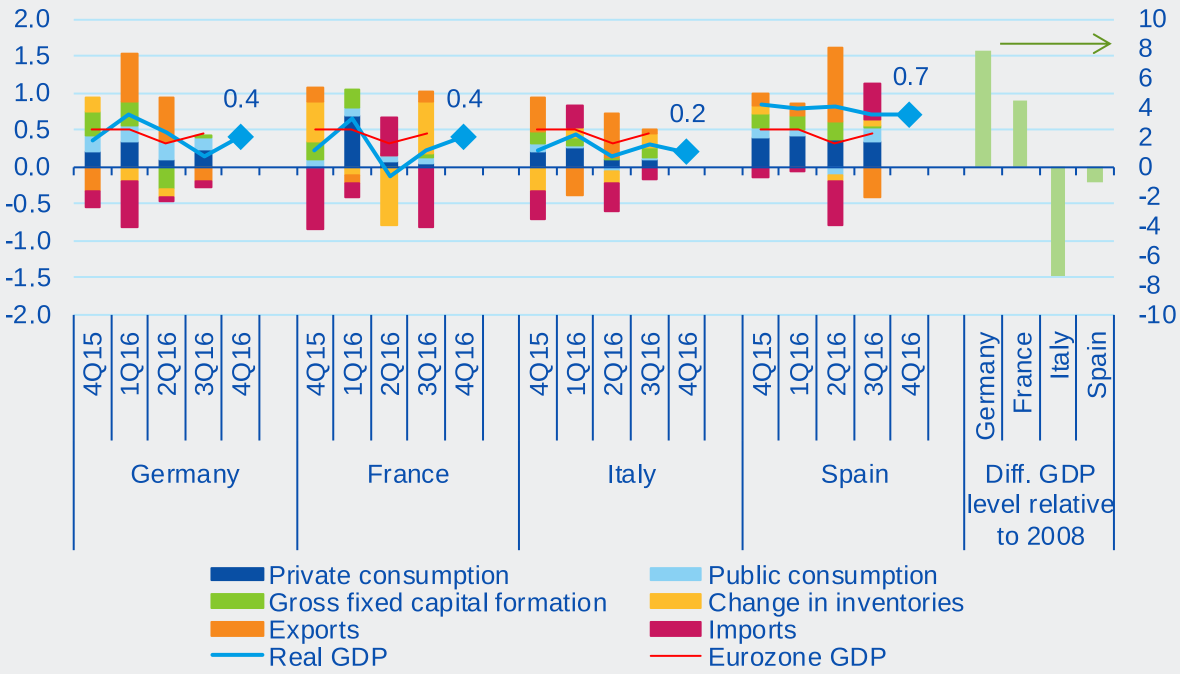
- **GDP showed stable growth** in 4Q16, increasing 0.4% QoQ again
- We expect the **4Q16 figure to be lead by consumption, while investment could have increased markedly…**
- **… supported by increasing exports** (higher global growth and euro depreciation) **but also construction** (Germany). Net exports could weigh on growth due to larger imports

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

Germany and France GDP accelerated in 4Q16, while Italy slowed down

GDP, CONTRIBUTION BY COMPONENTS
(%QoQ, pp)



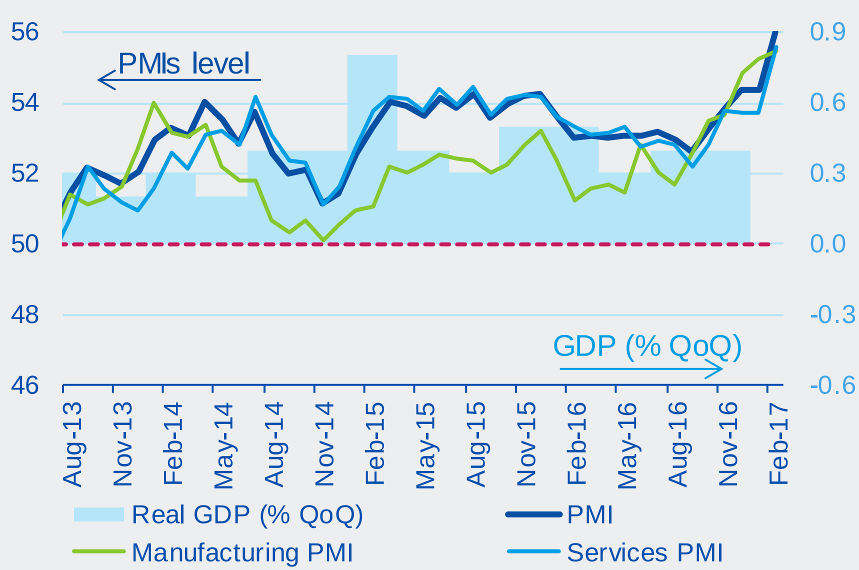
- In both **Germany and France preliminary GDP growth accelerated to 0.4% QoQ** in 4Q16. A recovery in exports probably added to positive contributions from consumption and investment
- **Italy's GDP growth slowed down** to 0.2% QoQ in 4Q16, apparently due to lower contribution from consumption, partially offset by the recovery of external demand
- **Spain continues to outperform** the region showing a preliminary GDP increase of 0.7% QoQ in 4Q16

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

Confidence figures signal a positive 2017 kick-off

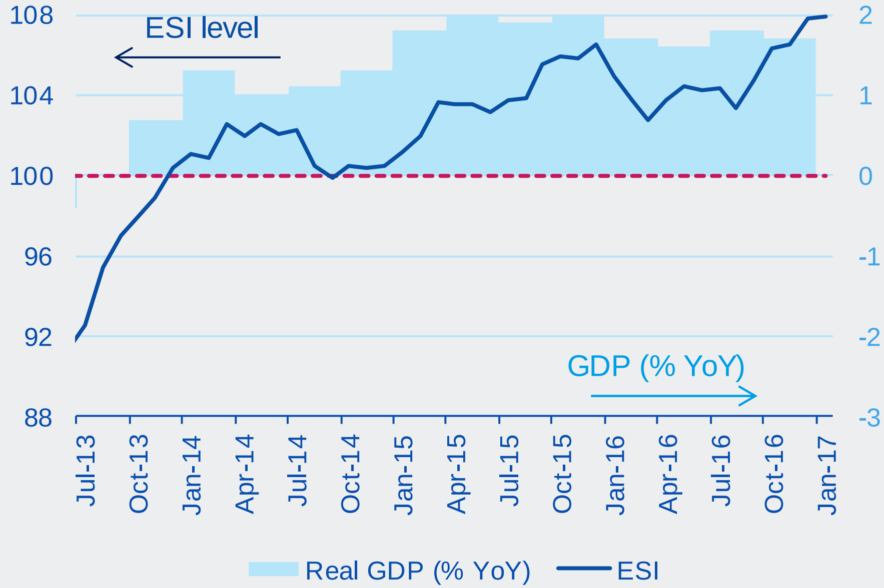
PMI AND GDP
(level, %QoQ)



- Confidence data **surprised to the upside in February driven mostly by services,** suggesting **an acceleration of growth in EZ in 1Q17**

Source: Eurostat and BBVA Research

ESI AND GDP
(level, %YoY)



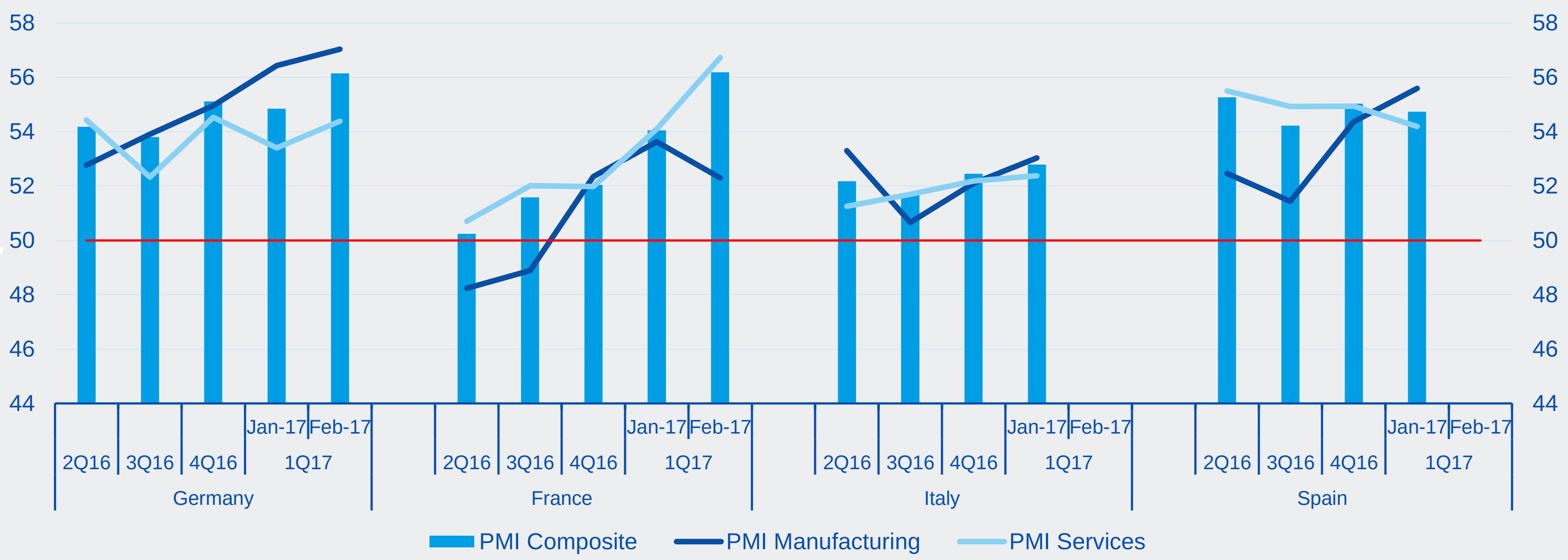
- However, there remains a significant **risk of political events** potentially affecting the recovery

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

Overall manufacturing PMIs improved in core countries at the start of 1Q17 but with mixed signals in services

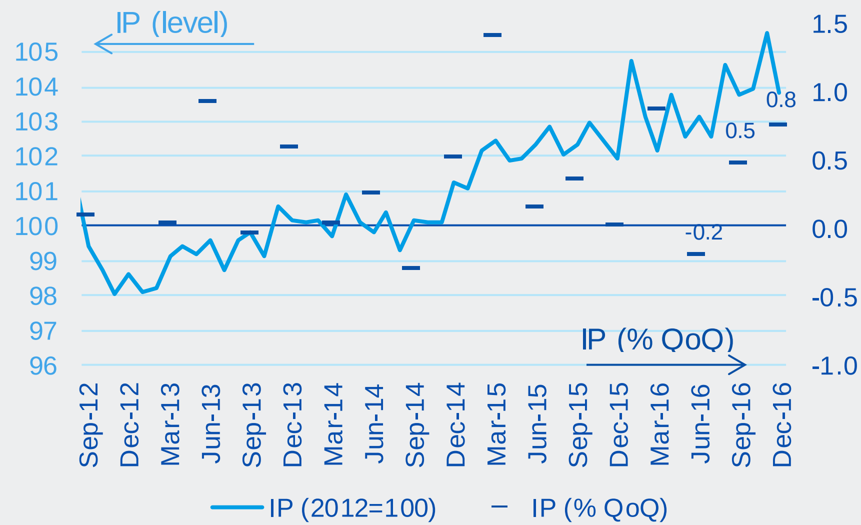
PMI
(level)



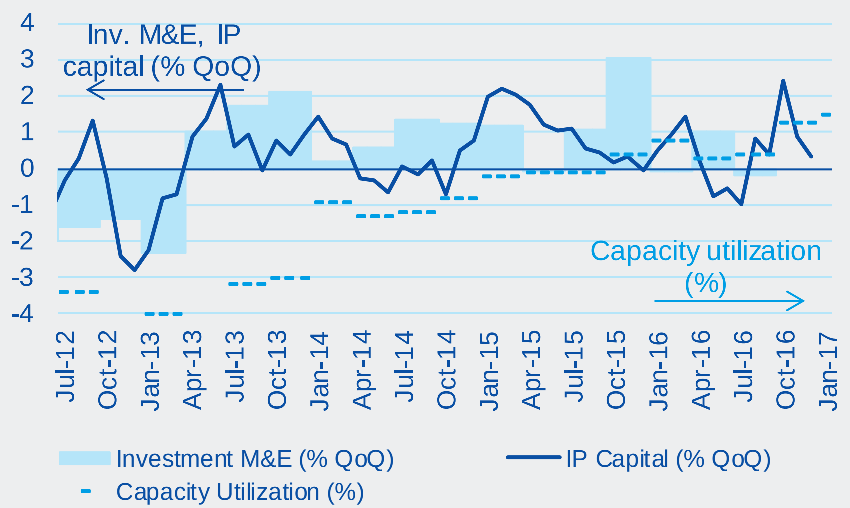
ECONOMIC DEVELOPMENTS

Despite the fall in December, industrial production maintains the positive trend of last quarters

INDUSTRIAL PRODUCTION
(%QoQ, pp)



IP CAPITAL, INVESTMENT IN MACHINERY AND EQUIPMENT AND UTILIZATION CAPACITY
(%QoQ, %)



- Industrial production **dropped 1.6% MoM in December** after an increase of 1.5% MoM in November, **closing 4Q16 with an overall growth of 0.8% QoQ** (3Q16: 0.5% QoQ)

- Production of **capital goods** eased in December. Nonetheless **durable consumer goods** accelerated along with **high capacity utilization,** suggesting a recovery in equipment and machinery investment in 4Q16

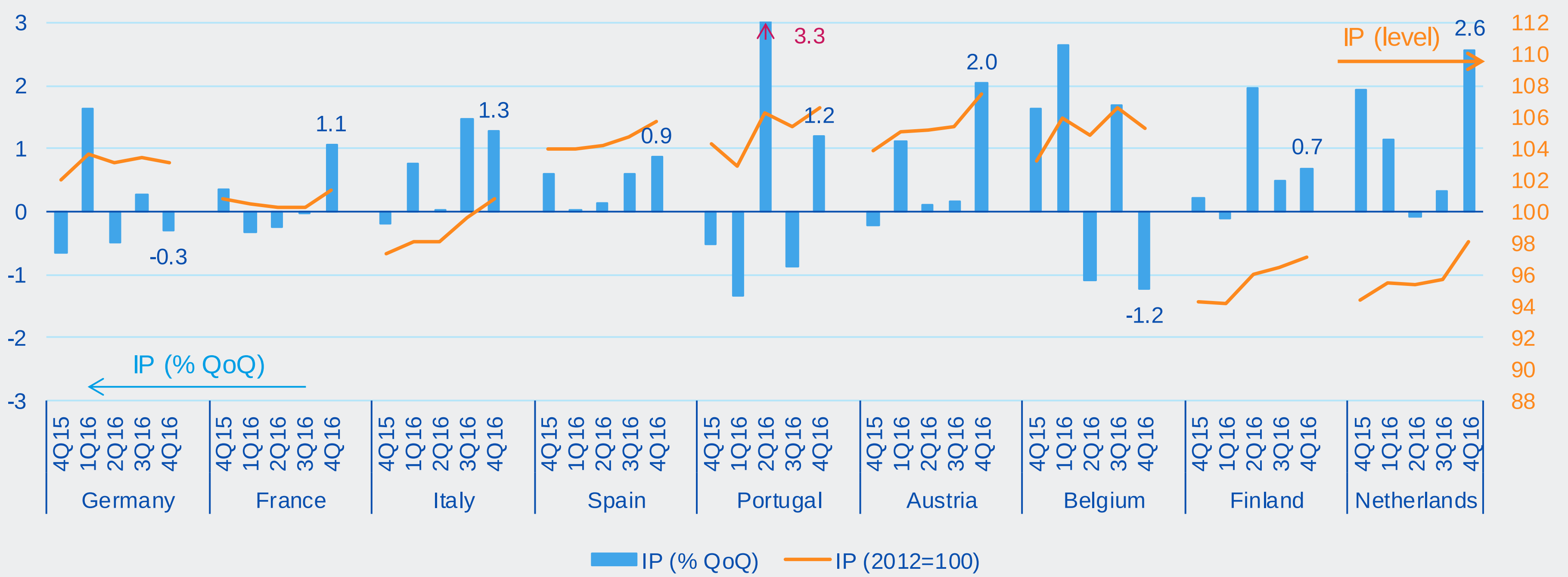
Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

Recovery of industrial output growth across countries in 4Q16, except in Germany and Belgium

INDUSTRIAL PRODUCTION
(%QoQ, pp)

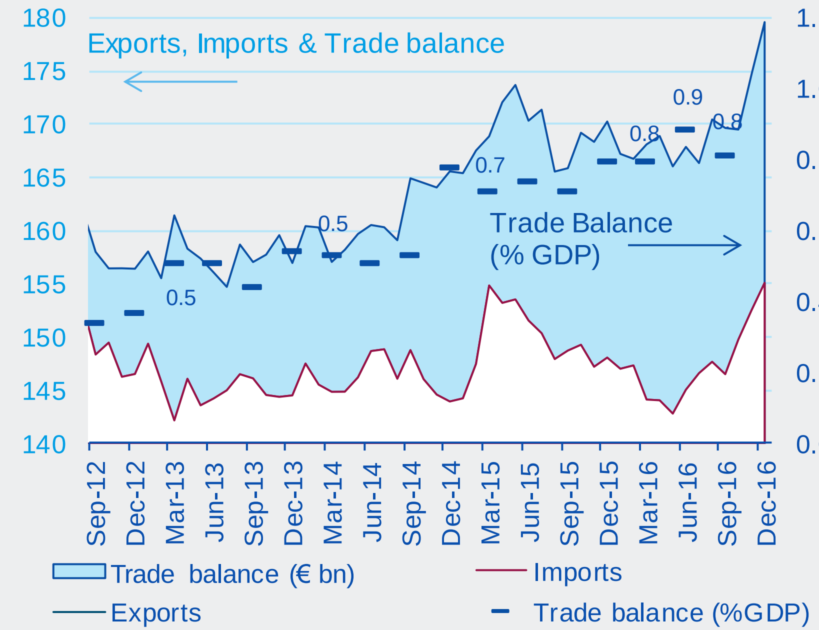


Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

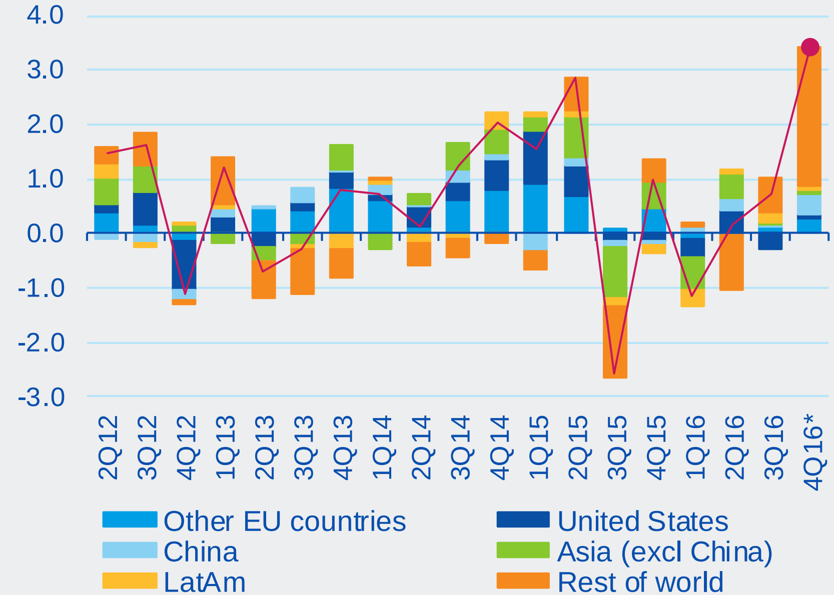
Exports accelerated sharply in 4Q16 on the back of improved global demand and euro depreciation

TRADE BALANCE
(€ bn, %GDP)



Source: Eurostat and BBVA Research

EXPORTS CONTRIBUTION BY DESTINATION
(%QoQ, pp)

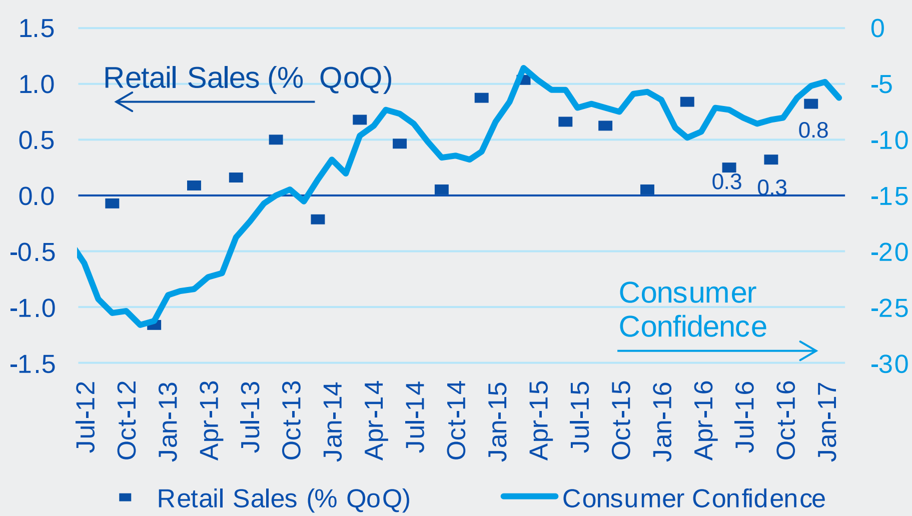


*October and November with respect to three previous months
Source: Eurostat and BBVA Research

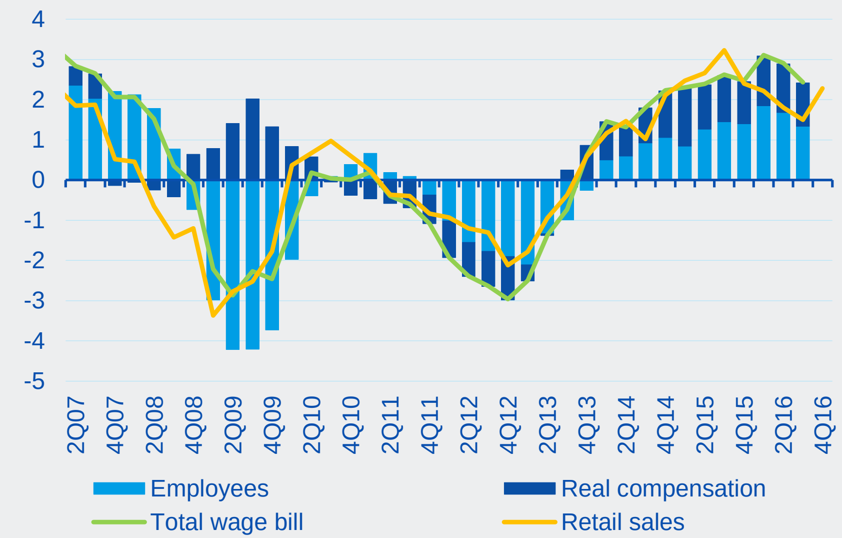
ECONOMIC DEVELOPMENTS

Retail sales exhibited a solid growth over 4Q16 despite disappointing figures at the end of the quarter

RETAIL SALES AND CONSUMER CONFIDENCE
(%QoQ, pts)



RETAIL SALES AND TOTAL WAGE BILL
(%YoY)



- **Retail sales declined again in December** (-0.3% after -0,6 MoM in November). Nonetheless, overall figures for 4Q16 (+0.8% QoQ) point to a positive contribution of private consumption to GDP growth

- **Consumer confidence fell more than expected in February** suggesting some steam maybe coming out of the consumption recovery

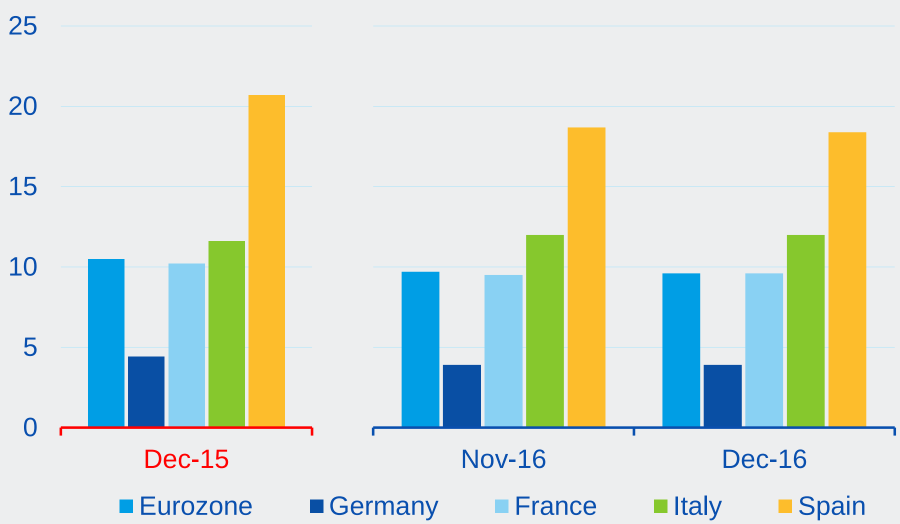
Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

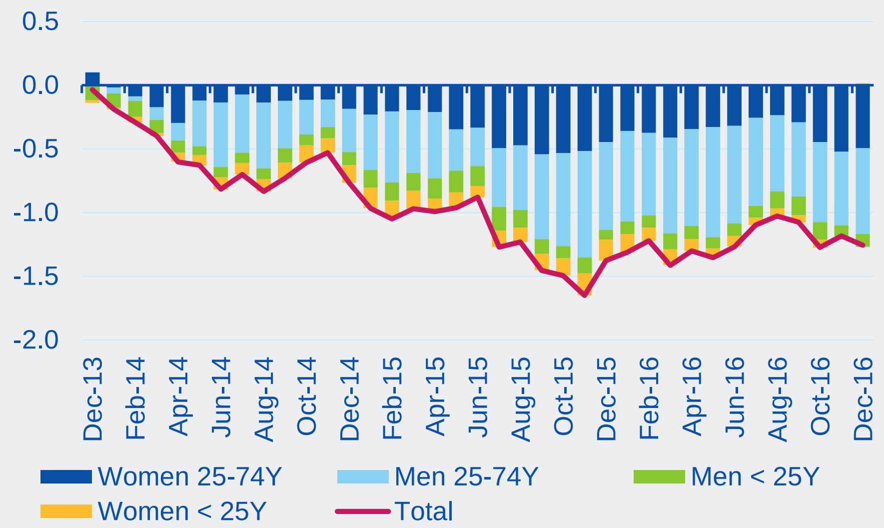
ECONOMIC DEVELOPMENTS

Eurozone unemployment rate continues to decline and reaches its lowest level since 2009

UNEMPLOYMENT RATE BY COUNTRY
(%)



ANNUAL UNEMPLOYMENT CHANGE BY GENDER & AGE
(millions)



- **Jobless rate reached 9.6% in December 2016 and continues to fall at a low pace,** driven mostly by Spain

- **Unemployed decline** is observed mostly among the **experienced population**

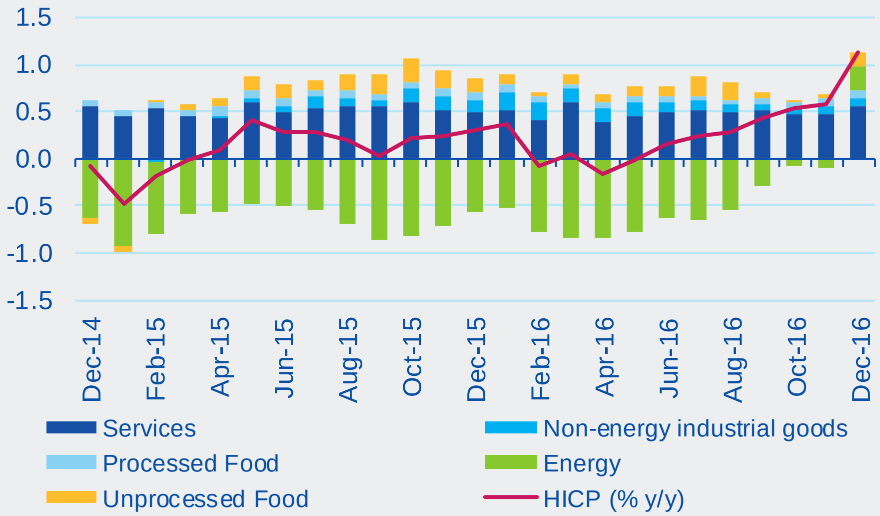
Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

Annual headline inflation rose up to 1.8% YoY in January driven by energy prices, while the core rate remained unchanged

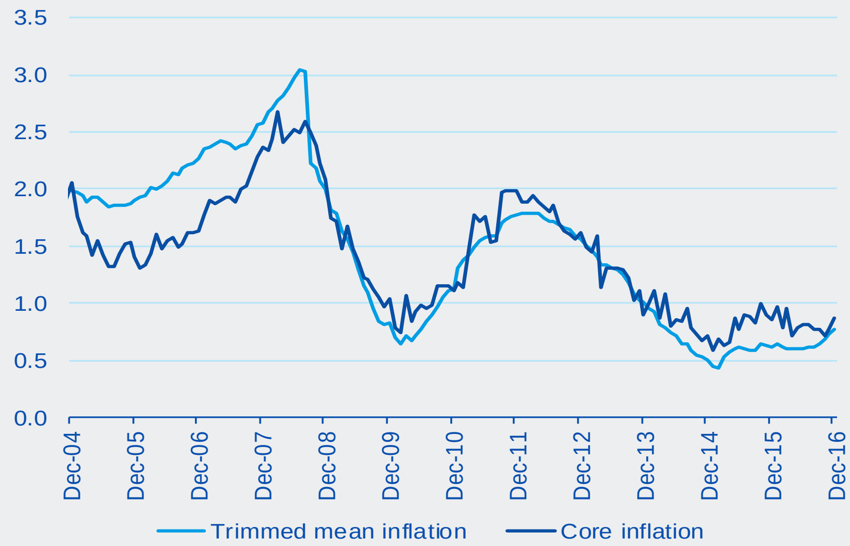
INFLATION AND CONTRIBUTION OF COMPONENTS
(%YoY, pp)



- Eurozone **HCPI** came out above expectations in January (+1.8% YoY), increasing +0.7pp on the back of a sharp rise in energy inflation

Source: Eurostat and BBVA Research

INFLATION AND TRIMMED MEAN
(%YoY)



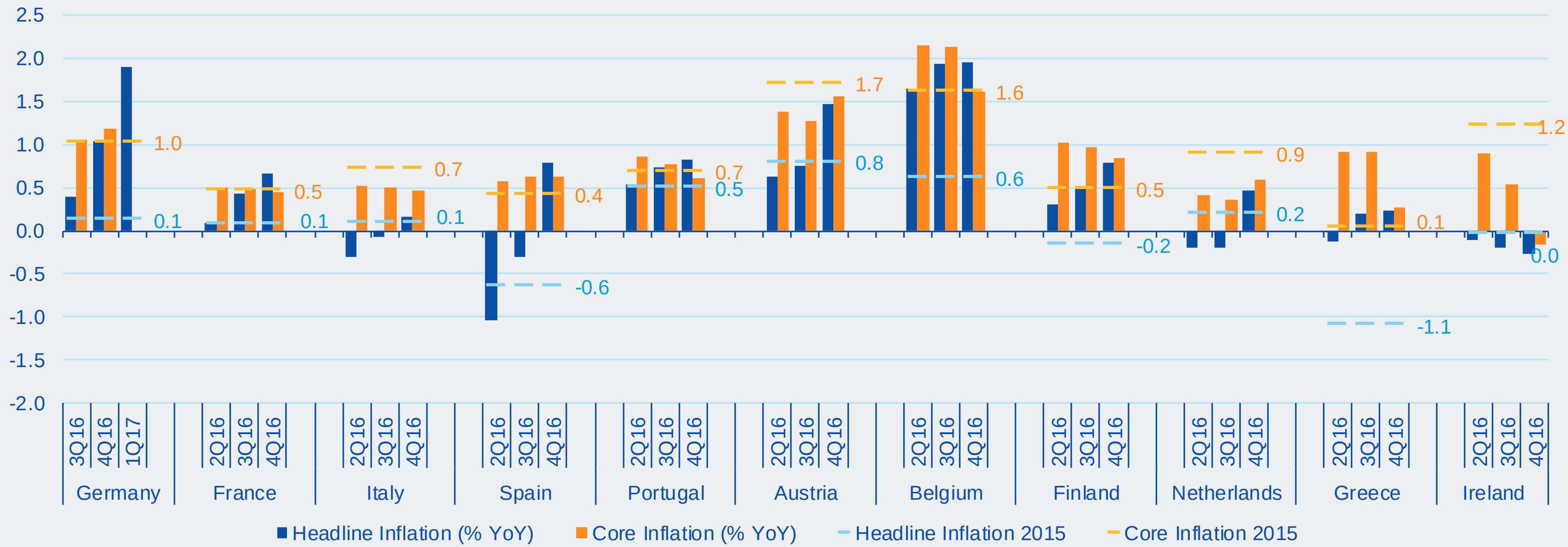
- Nonetheless **the core measure remained unchanged** at 0.9% YoY
- We expect **inflation to reach a peak of around 2% in the coming months and then moderate somewhat**

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

The acceleration of inflation is widespread, but with differences across countries

HEADLINE AND CORE INFLATION
(%YoY)



- By country, **HCPI inflation picked up in all core countries** in December 2016: **Spain** (1.4% after 0.5% YoY), **Italy** (0.5% after 0.1% YoY) and **France** (0.8% after 0.7% YoY). In January, **Germany HCPI** rose to 1.9% from 1.7% previously, supported by energy and unprocessed food prices

Source: Eurostat and BBVA Research

UPDATED FORECASTS: STEADY RECOVERY PROCEEDS, RISKS TO THE DOWNSIDE

FEBRUARY 2016

UPDATED FORECASTS

Growth drivers for the eurozone

Stronger confidence

Resilience of domestic drivers despite of higher uncertainty

Supportive economic policies: very relaxed monetary conditions and non-restrictive fiscal policies

Gradual improvement in world trade along with a weaker euro

Lower tailwinds from oil prices are pushing up inflation, adding pressure on interest rates

Global outlook positive but with many uncertainties

Political risks in many countries in the region (several election over next months)

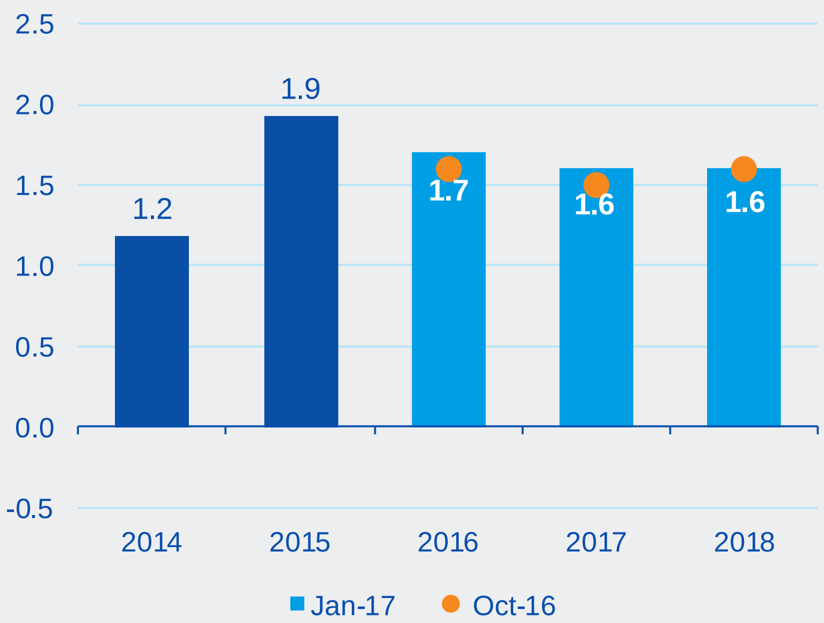
Unresolved problems

Hard Brexit

UPDATED FORECASTS

Eurozone: steady recovery led us to revise slightly up GDP growth in 2017-18 but with caution due to a very uncertain policy environment

GDP GROWTH AND FORECAST
(%)



MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016	2017 (f)	2018 (f)
Real GDP	**1.9**	**1.7**	**1.6**	**1.6**
Private consumption	1.8	1.7	1.4	1.4
Public consumption	1.4	1.9	1.3	1.0
Investment	2.9	2.9	2.8	3.1
Domestic demand (cont. pp)	**1.7**	**1.9**	**1.6**	**1.6**
Exports	6.2	2.4	3.7	3.9
Imports	6.2	3.2	4.1	4.4
Net exports (cont. pp)	**0.3**	**-0.2**	**0.0**	**0.0**
Current account (% GDP)	3.1	3.2	2.9	2.8
Budget balance (% GDP)	-2.1	-1.9	-1.8	-1.7
HICP (avg. %YoY)	0.0	0.2	1.6	1.6

- **Domestic demand remains as the main driver of growth,** still supported by monetary policy and, to a much lesser extent, fiscal policy

- Minor revisions in growth composition: **slightly stronger contribution from investment** and to a lesser extent from exports, not enough to offset slowing consumption

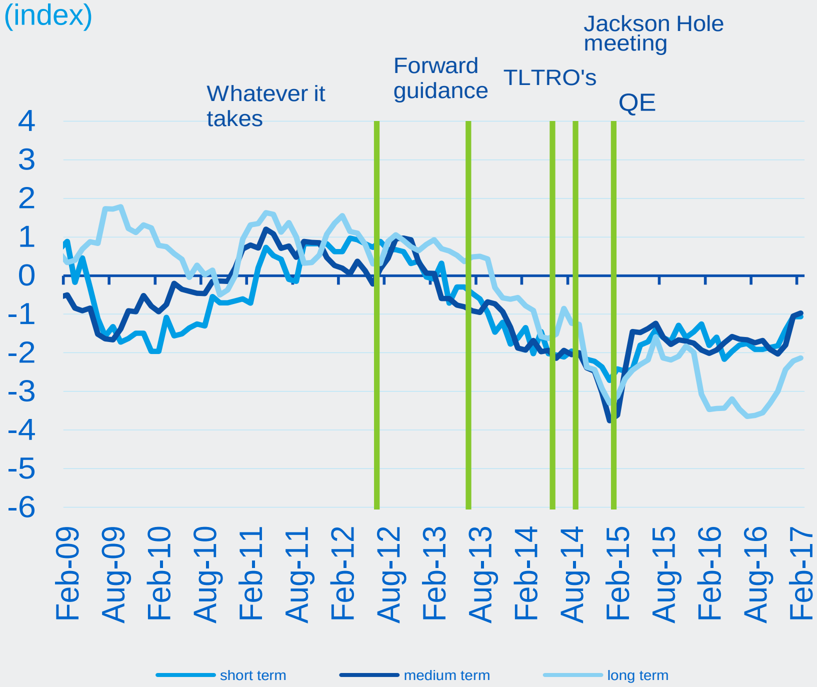
Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

UPDATED FORECASTS

ECB to remain "patient" in the coming months despite the recent upturn of headline inflation

BBVA EZ INFLATION MONITOR
(index)



What happened

ECB extended QE until December 2017, or beyond if necessary

Monetary policy has remained highly supportive despite improving growth and confidence figures

Next steps

The key will be to observe how core inflation develops, but pressures should remain subdued

Tappering talks could arise after Summer

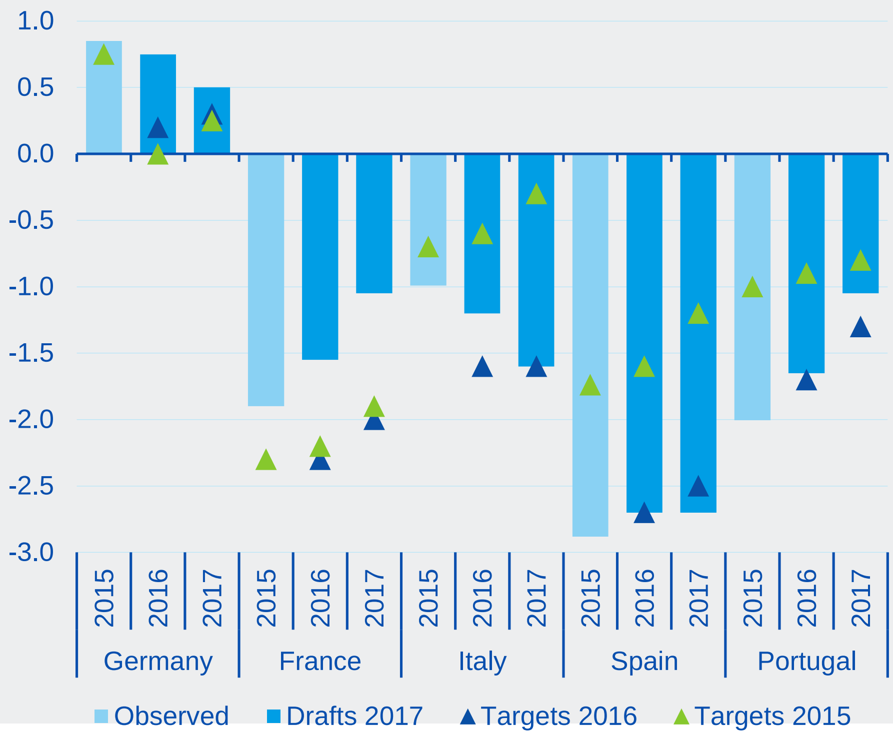
We expect the **end of QE by around mid-2018 and the first rate hike by December 2018**

Source: Eurostat and BBVA Research

UPDATED FORECASTS

Fiscal policy will continue to be supportive, but with high heterogeneity across countries

STRUCTURAL BALANCES: OBSERVED, BUDGET DRAFTS AND TARGETS
(% Potential GDP)



- **The path of consolidation has slowed down**
- Ongoing fiscal adjustment lies in **the improvement of cyclical budget**
- Fiscal policy **slightly expansionary in the eurozone as a whole…**
- **… but not much margin in Italy an Spain**

Source: Eurostat, Stability and Convergence Programs and BBVA Research

UPDATED FORECASTS

Germany: loosening steam in 2017, as improving global demand is unlikely to offset weaker domestic drivers

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016 (f)	2017 (f)	2018 (f)
Real GDP	**1.5**	**1.8**	**1.6**	**1.6**
Private consumption	1.9	1.7	1.5	1.3
Public consumption	2.8	4.3	2.3	1.4
Investment	1.1	1.9	1.9	2.5
Domestic demand (cont. pp)	**1.3**	**2.0**	**1.7**	**1.6**
Exports	4.6	2.1	3.0	3.4
Imports	5.0	3.0	3.7	3.8
Net exports (cont. pp)	**0.1**	**-0.3**	**-0.1**	**0.1**
Current account (% GDP)	8.4	8.8	7.7	7.2
Budget balance (% GDP)	0.7	0.6	0.3	0.3
HICP (avg. %YoY)	0.1	0.4	1.9	1.8

- **Solid performance in 2016** (1.8%) mainly driven by domestic demand
- Tightened labour market along with moderated wage rises and higher inflation could result in **lower real income and thus private consumption in 2017…**
- **… while the public expenditure is likely to moderate** after increasing last year due to refugees' accommodation expenses…
- … **and investment in machinery and equipment is expected to remain subdued** due to higher uncertainty
- **Improving global demand, still sluggish,** will not offset the lower contribution of domestic demand, while there are risks from lower trade, especially in the UK

Source: Eurostat and BBVA Research

UPDATED FORECASTS

France: moderate recovery seems to change gear despite higher political uncertainty

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016 (f)	2017 (f)	2018 (f)
Real GDP	**1.2**	**1.1**	**1.3**	**1.5**
Private consumption	1.5	1.8	1.5	1.5
Public consumption	1.4	1.5	1.3	1.1
Investment	0.9	2.8	2.0	2.3
Domestic demand (cont. pp)	**1.5**	**2.0**	**1.5**	**1.5**
Exports	6.0	0.8	3.4	3.6
Imports	6.4	3.5	3.7	3.2
Net exports (cont. pp)	**-0.3**	**-0.9**	**-0.2**	**0.0**
Current account (% GDP)	-0.2	-1.0	-1.4	-1.1
Budget balance (% GDP)	-3.5	-3.3	-2.7	-2.6
HICP (avg. %YoY)	0.1	0.3	1.3	1.4

- **GDP growth slowed in 2016 to 1.1%** dragged by net exports that offset the strengthening of private consumption and investment
- **Political uncertainty** driven by **upcoming elections** could weigh over consumer and business and confidence over the first half of the year, partly offset by increasing employment
- In this context, **both private consumption and investment growth are expected to decelerate…**
- **…** adding to an ongoing fiscal adjustment in 2017
- **The exports recovery observed over 2H16 is expected to consolidate this year**, and thus net exports should not drain much growth

Source: Eurostat and BBVA Research

UPDATED FORECASTS

Italy: idiosyncratic uncertainty to tame the recovery

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016 (f)	2017 (f)	2018 (f)
Real GDP	**0.6**	**1.0**	**1.0**	**1.2**
Private consumption	1.5	1.4	0.9	1.0
Public consumption	-0.6	0.6	0.2	0.3
Investment	1.1	2.0	2.1	2.4
Domestic demand (cont. pp)	**1.0**	**1.0**	**0.9**	**1.1**
Exports	4.0	1.3	3.1	3.3
Imports	5.8	1.7	2.7	3.1
Net exports (cont. pp)	**-0.4**	**-0.1**	**0.2**	**0.1**
Current account (% GDP)	1.7	2.7	2.6	2.5
Budget balance (% GDP)	-2.6	-2.4	-2.3	-2.1
HICP (avg. %YoY)	0.1	-0.1	1.4	1.4

- **Recovery gained some momentum in 2016** as net exports did not weigh as much on growth, **but it is still lagging**
- **Political uncertainty and banking sector worries** weighed on domestic demand, mainly private consumption, though the Jobs Act reform and fiscal incentives seemed to support job creation
- **Net exports will again contribute to growth this year**, but will be less supportive than in other peripheral countries…
- **…** as well as **more subdued investment,** which could be curbed in the forecast horizon by expectations of a sluggish recovery

Source: Eurostat and BBVA Research

UPDATED FORECASTS

Spain: robust growth, but with a slowdown

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016 (f)	2017 (f)	2018 (f)
Real GDP	**3.2**	**3.2**	**2.7**	**2.7**
Private consumption	2.9	3.0	2.5	2.4
Public consumption	2.0	1.3	1.8	1.9
Investment	6.0	3.6	3.3	4.4
Domestic demand (cont. pp)	**3.3**	**2.8**	**2.4**	**2.6**
Exports	4.9	4.3	4.5	5.2
Imports	5.6	3.2	3.8	5.5
Net exports (cont. pp)	**-0.1**	**0.5**	**0.3**	**0.1**
Current account (% GDP)	1.4	2.0	1.9	1.8
Budget balance (% GDP)	-5.0	-4.4	-3.0	-2.1
HICP (avg. %YoY)	-0.5	-0.2	2.1	1.9

- **Slight upward GDP growth revision** to 2.7% in 2017 and 2018…
- …but **symptoms of lower growth** as tailwinds slacken: already affecting both household consumption and investment in machinery and equipment
- **Fiscal policy stance will shift from expansive to neutral** in 2017-18
- **Exports are recovering** in spite of Brexit
- Risks remain related to ongoing **fiscal consolidation and political uncertainty** (decreasing but still relevant)

Source: Eurostat and BBVA Research

Eurozone

Economic Watch

FEBRUARY 2017

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