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Eurozone Economic Watch

APRIL 2017

Eurozone: A more upbeat outlook, but still surrounded by (mostly political) risks

- **Improving confidence** across sectors and major countries **continued at the start of 2017 while growth momentum seems to take root in 1Q17,** driven mostly by improved global demand and a weak euro…
- … but **hard data up to February such as industrial output and retail sales begin to moderate, though foreign trade clearly improves**
- Our **MICA-BBVA model** for short-term growth estimates a quarterly **GDP figure in the eurozone of 0.5% QoQ in 1Q17**
- **Growth forecasts for 2017-18 are revised slightly upwards to 1.7% (+0.1pp) in both years**, driven by improving global demand. Domestic drivers remain broadly unchanged, as well as the accommodative monetary stance and non-restrictive fiscal measures in the pipeline for the eurozone as a whole
- **Germany and Spain will continue to perform better than France and Italy** over the forecast horizon, but there is some tendency to convergence
- **Inflation pressures are still subdued.** Headline inflation is expected to be higher in 2017 (+0.2pp to 1.8%) but still below 2% in 2018 (1.6%) as energy price inflation fades. **Core inflation remains stable** slightly below 1% and is expected to increase gradually to around 1.5% by the end of the forecast horizon
- Despite the improvement in both global and European outlook, **risks to growth remain tilted to the downside, mainly due to domestic political issues** (2017) **and to China's pending adjustment** (in the long term)

Economic developments:
Increasing optimism, but it has yet to be confirmed in hard data

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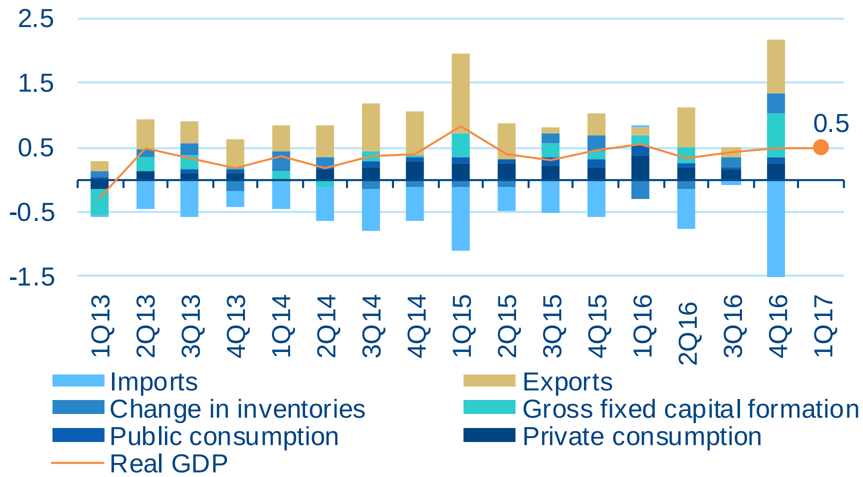
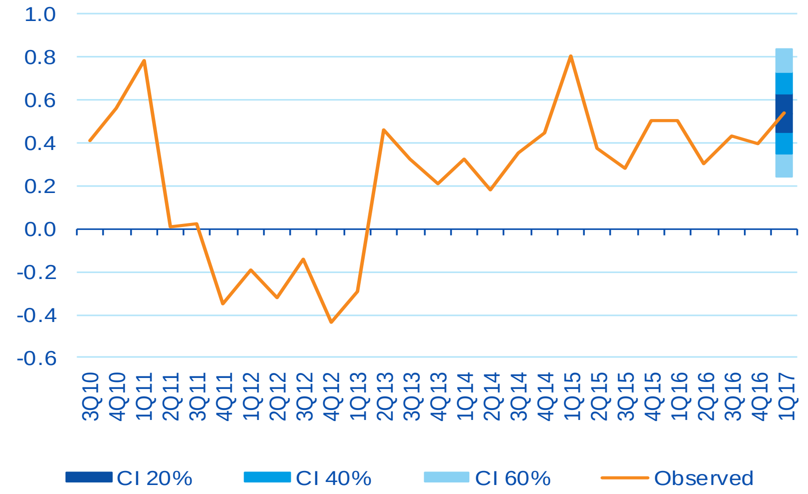
ECONOMIC DEVELOPMENTS

GDP growth in the EZ could be gaining momentum in 1Q17…

GDP, CONTRIBUTION BY COMPONENTS
(%QoQ, pp)



GDP AND MICA FORECASTS
(%QoQ)



- **Steady GDP growth in 4Q16** (0.4% QoQ). Consumption continued to underpin the recovery. Beyond volatility, **investment is growing at steady pace** since early 2015, while **exports gained traction**
- Available data continue to suggest that the **economy could have gained momentum in 1Q17**, but it has yet to be confirmed by hard data
- Our MICA-BBVA model suggests a quarterly **GDP growth of around 0.5% QoQ in 1Q17**, with positive contributions from both domestic and net external demand

Source: Eurostat and BBVA Research

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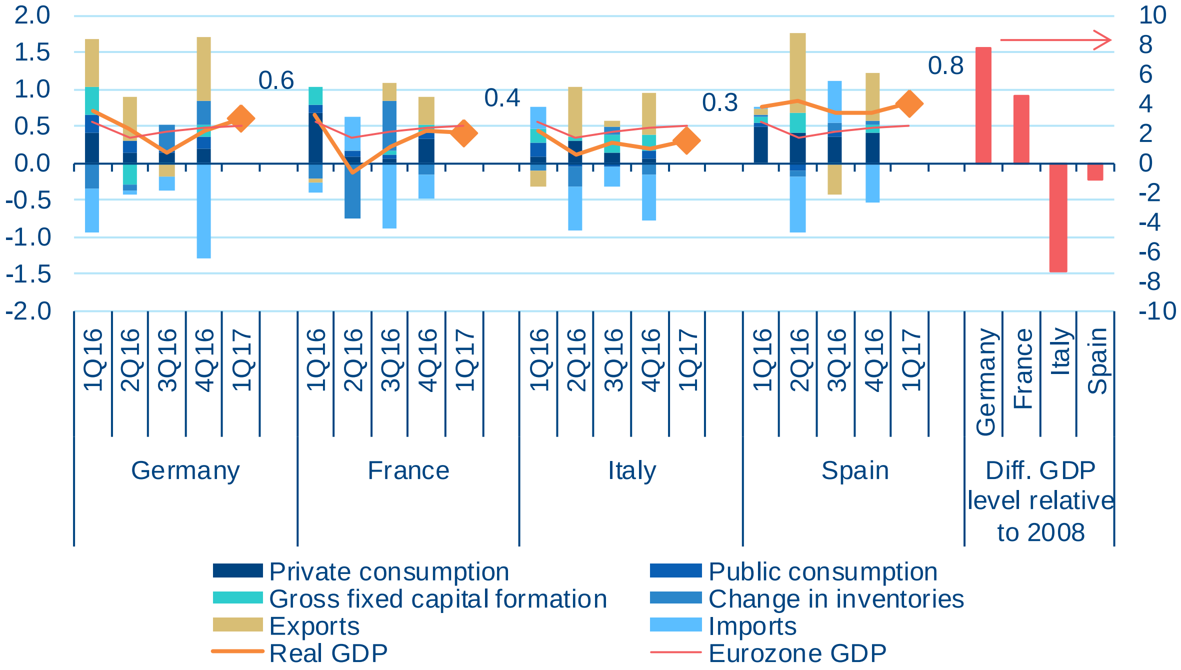
ECONOMIC DEVELOPMENTS

… and across countries, especially in Germany and Spain

GDP, CONTRIBUTION BY COMPONENTS
(%QoQ, pp)



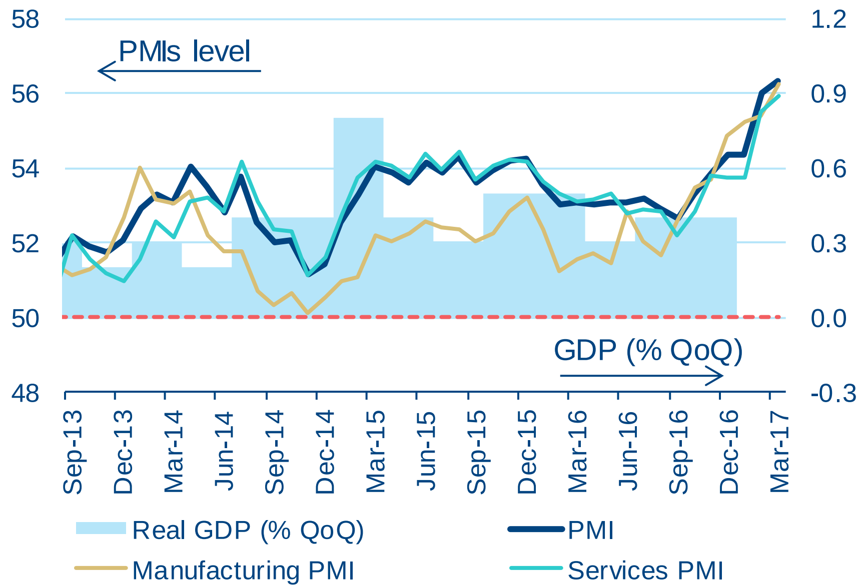
- Data for **1Q17 suggest further acceleration of GDP** growth across countries…
- **… with solid figures especially in Spain** (BBVAe: 0.8% after 0.7% QoQ) **and Germany** (BBVAe: 0.6% after 0.4% QoQ), supported by both domestic demand and exports
- **In Italy,** the recovery seems to proceed at a **modest pace** (BBVAe: 0.3% after 0.2% QoQ)
- **France continues to show steady GDP figures** (BBVAe: 0.4% QoQ) driven by domestic demand

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

Confidence figures continued to improve in 1Q17 across sectors …

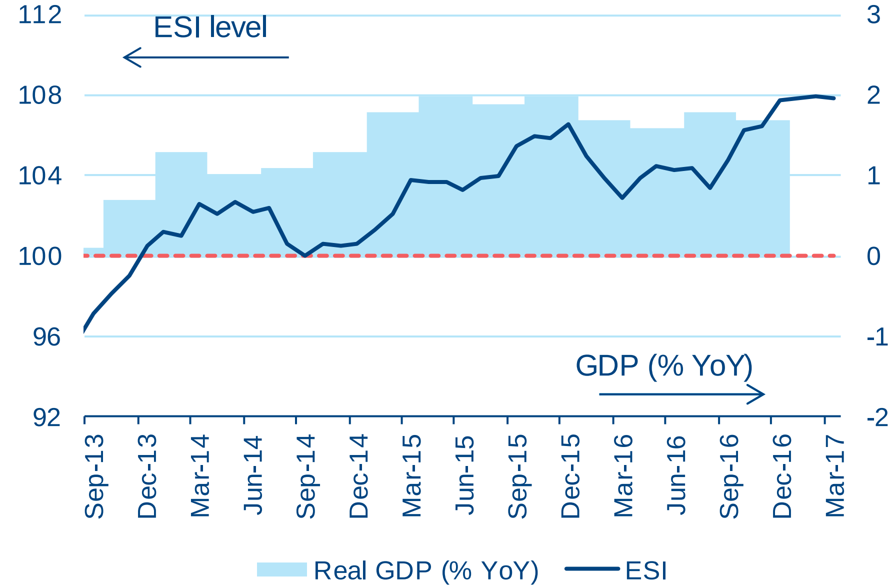
PMI AND GDP
(level, %QoQ)



- Confidence data **surprised once again to the upside in March** on the back of better confidence in both manufacturing and services sectors

Source: Eurostat and BBVA Research

ESI AND GDP
(level, %YoY)



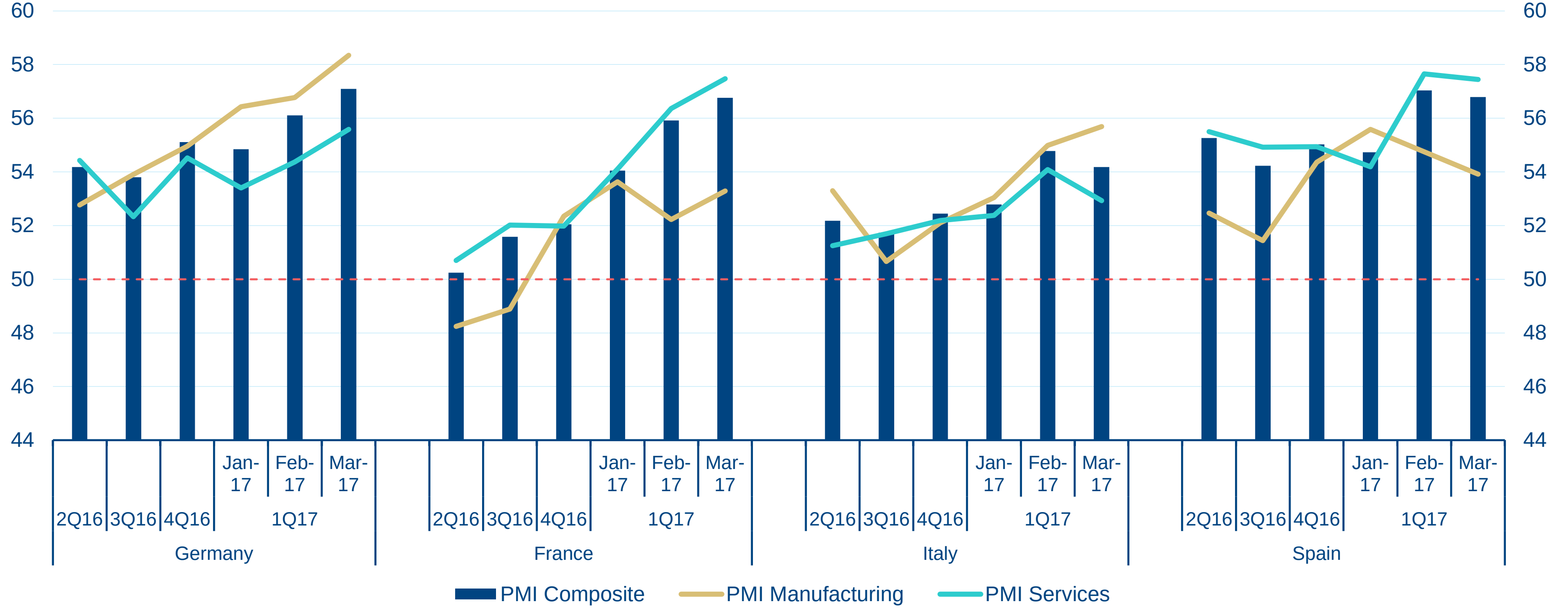
- Different **political** events **have not affected mood yet,** although remained as latent risks. In addition**, confidence from the European Commission** indicators showed some signs of **stabilisation over 1Q17**

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

… and also across major countries, especially in Germany and France

PMI
(level)

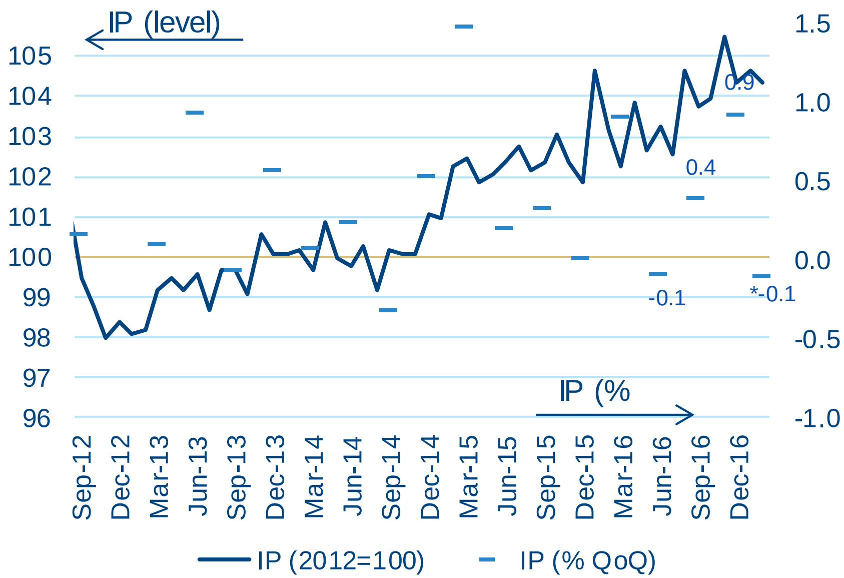


Source: Eurostat and BBVA Research

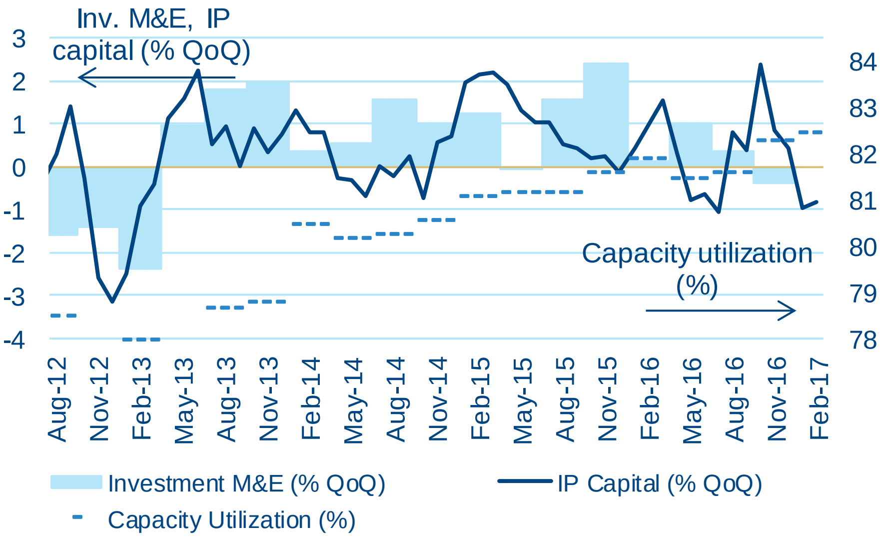
ECONOMIC DEVELOPMENTS

Industrial production has moderated recently, but the positive trend remains, especially in durable consumer and intermediate goods...

INDUSTRIAL PRODUCTION
(%QoQ, pp)



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



- Industrial production **flattened up to February over 4Q16,** driven by a marked **decline in energy output and non-durable consumer goods**…

- … but **the recovery in production of durables, intermediate and capital goods remains on track**, pointing to a bit favorable outlook in coming months

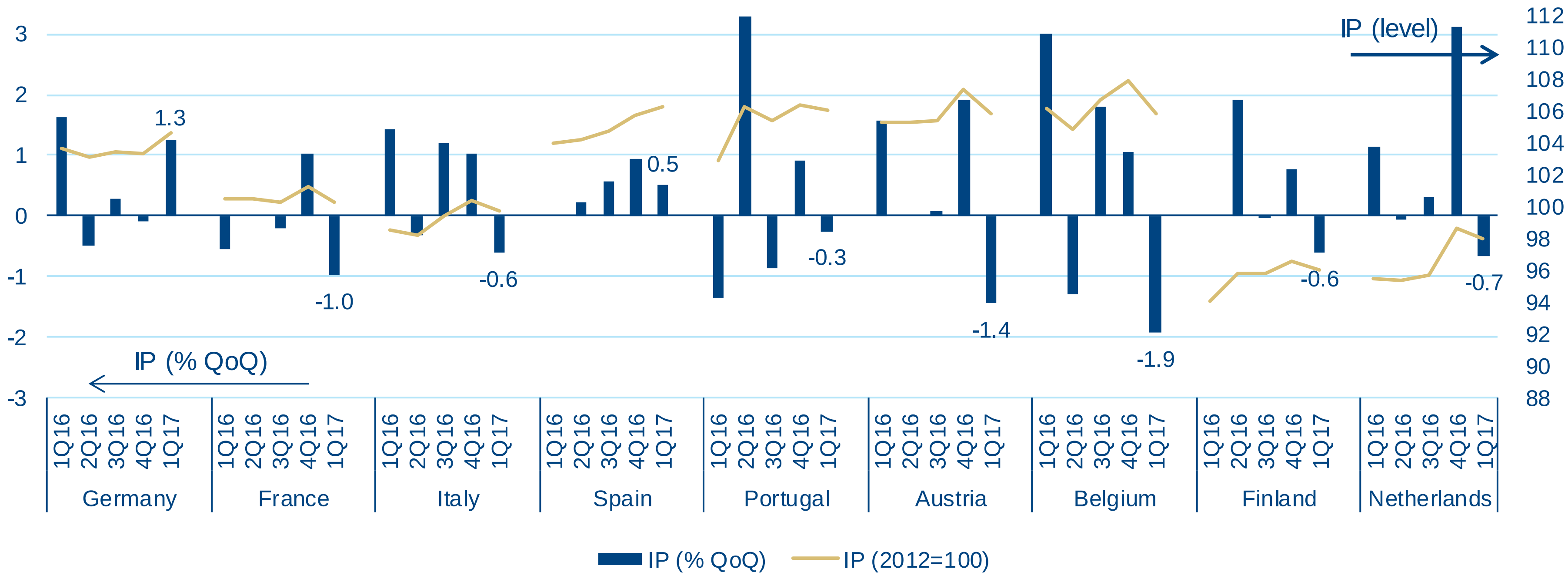
*1Q17 correspond to January and February with respect to three previous months
Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

… with a heterogeneous performance across countries. Industrial output improved only in Germany and Spain in 1Q17 so far

INDUSTRIAL PRODUCTION
(%QoQ, pp)*

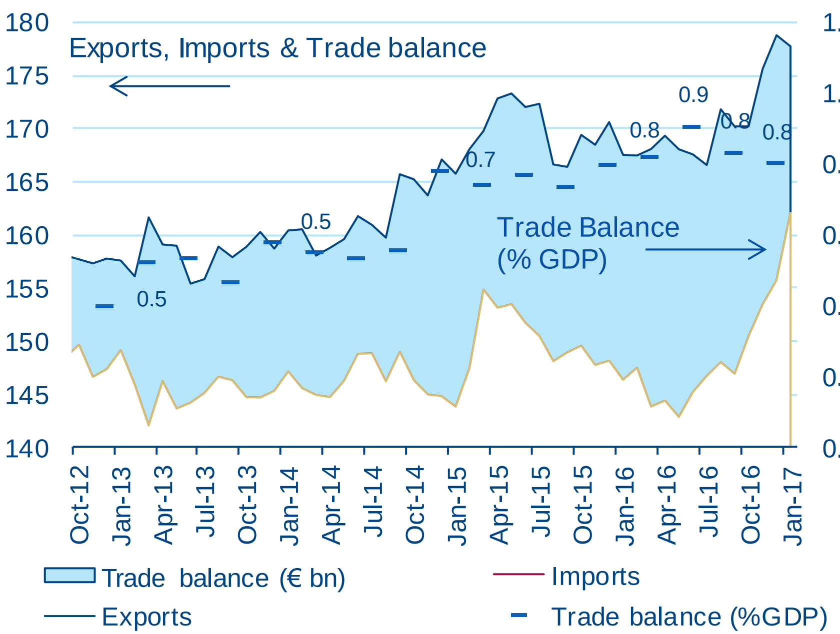


*1Q17 correspond to January and February with respect to three previous months
Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

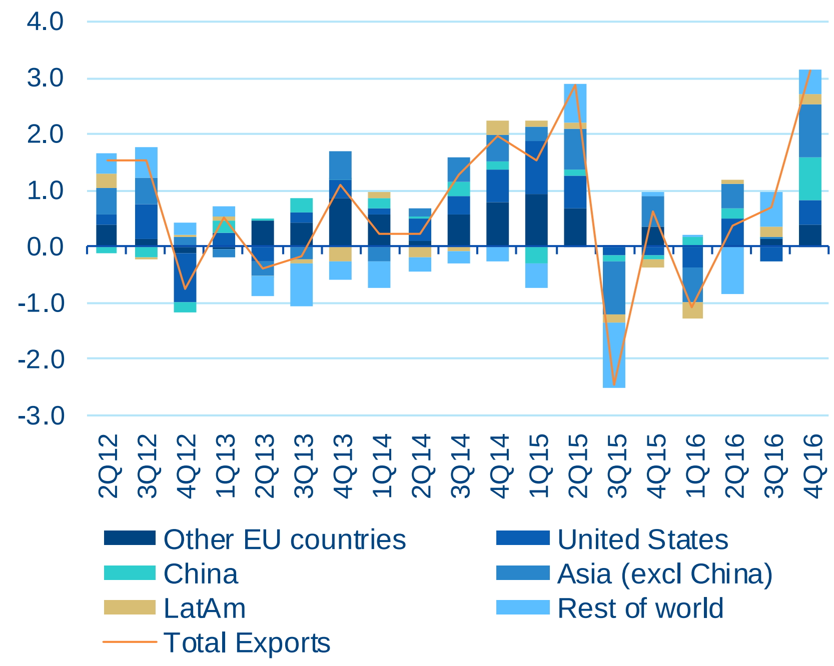
Sharp increase in imports, but also in exports supported by improving global demand

TRADE BALANCE
(€ bn, %GDP)



Source: Eurostat and BBVA Research

EXPORTS CONTRIBUTION BY DESTINATION
(%QoQ, pp)

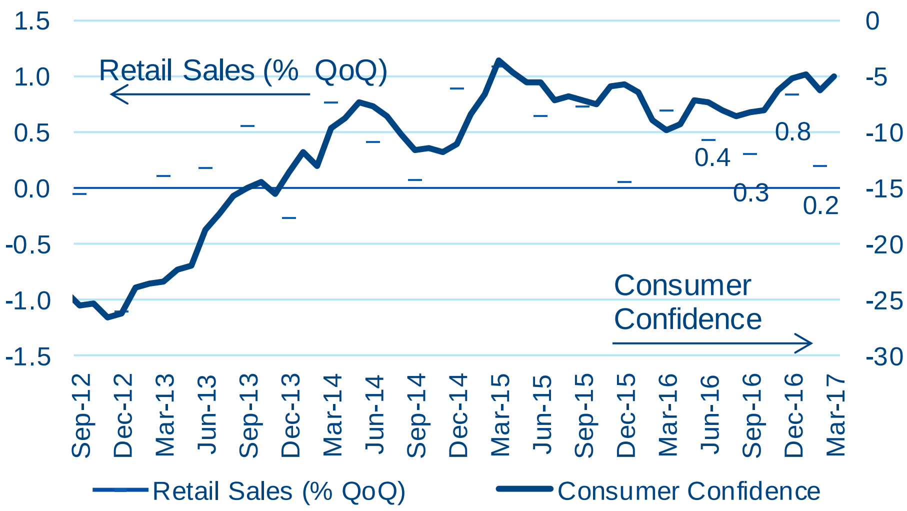


Source: Eurostat and BBVA Research

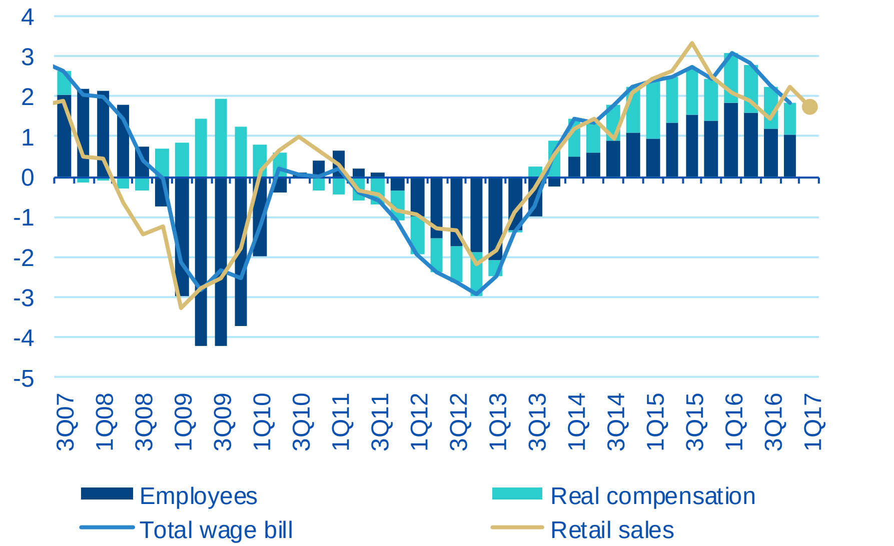
ECONOMIC DEVELOPMENTS

Retail sales growth moderates in 1Q17 despite the resilience of consumer confidence

RETAIL SALES AND CONSUMER CONFIDENCE
(%QoQ, pts)



RETAIL SALES AND TOTAL WAGE BILL
(%YoY)



- **Retail sales increased +0.7% MoM in February** after +0,1 MoM in January, decelerating after the rebound observed in 4Q16 (to +0.2% QoQ from 0.8% QoQ)
- **Consumer confidence rose more than expected in March** showing resilience to the incipient signs of erosion in real wages

Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

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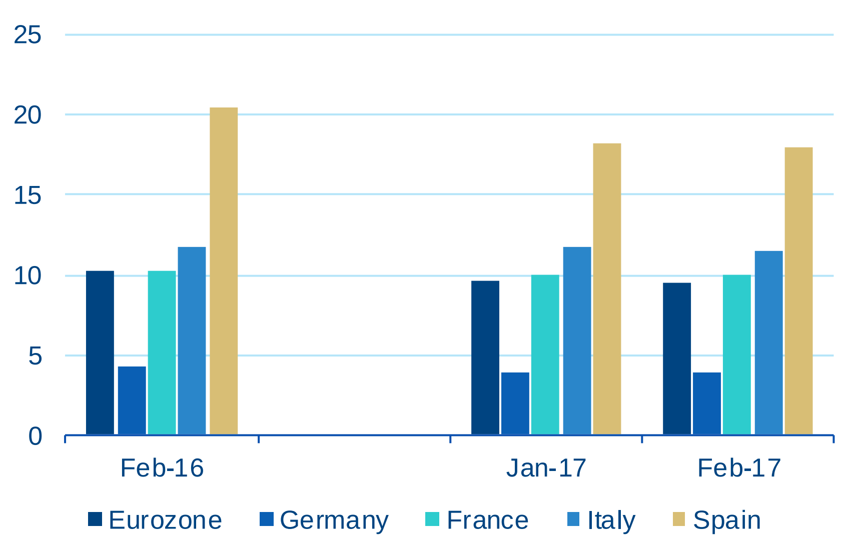
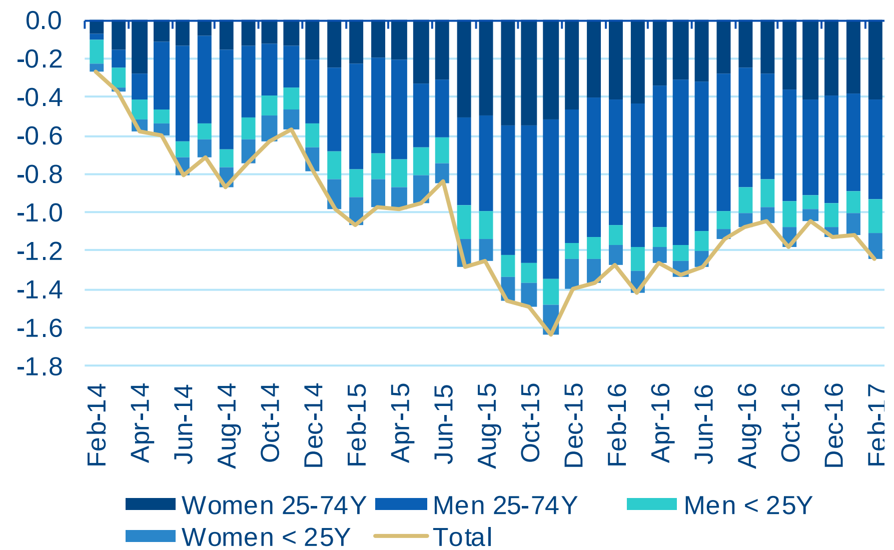
ECONOMIC DEVELOPMENTS

The unemployment rate declined again earlier in the year, albeit at a slow pace

UNEMPLOYMENT RATE BY COUNTRY
(%)



ANNUAL UNEMPLOYMENT CHANGE BY GENDER & AGE
(millions)



- **Jobless rate reached 9.5% in February and continues to fall at a low pace,** driven mostly by Spain and Italy

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

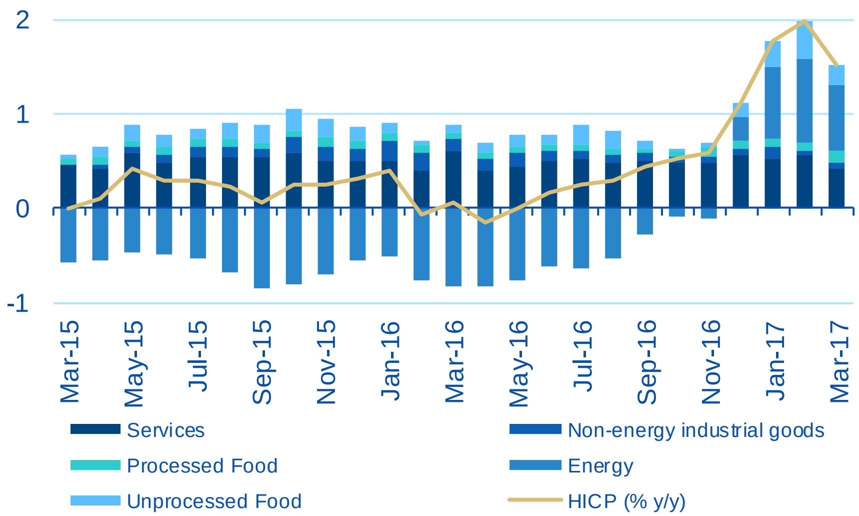
Source: Eurostat and BBVA Research

Source: Eurostat and BBVA Research

ECONOMIC DEVELOPMENTS

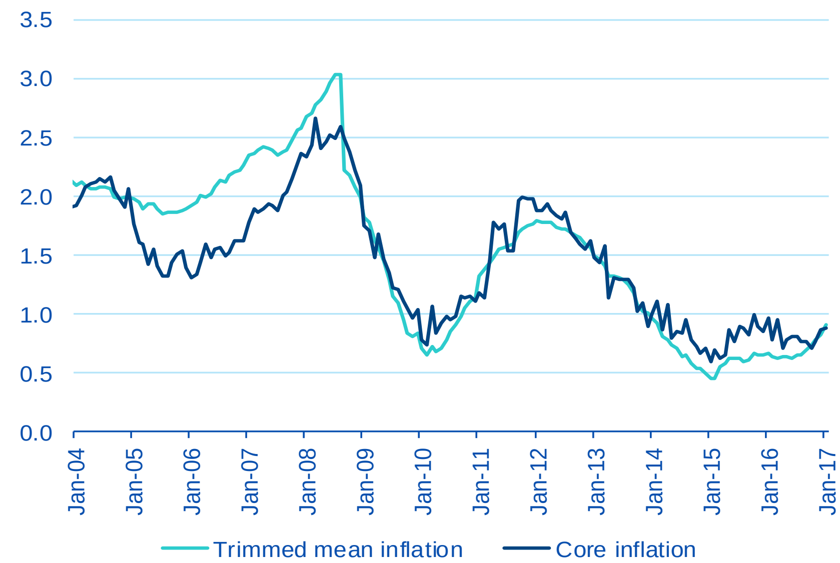
Headline and core inflation fell in March driven by more volatile components and the calendar effects on service prices

INFLATION AND CONTRIBUTION OF COMPONENTS
(%YoY, pp)



Source: Eurostat and BBVA Research

INFLATION AND TRIMMED MEAN
(%YoY)



Source: Eurostat and BBVA Research

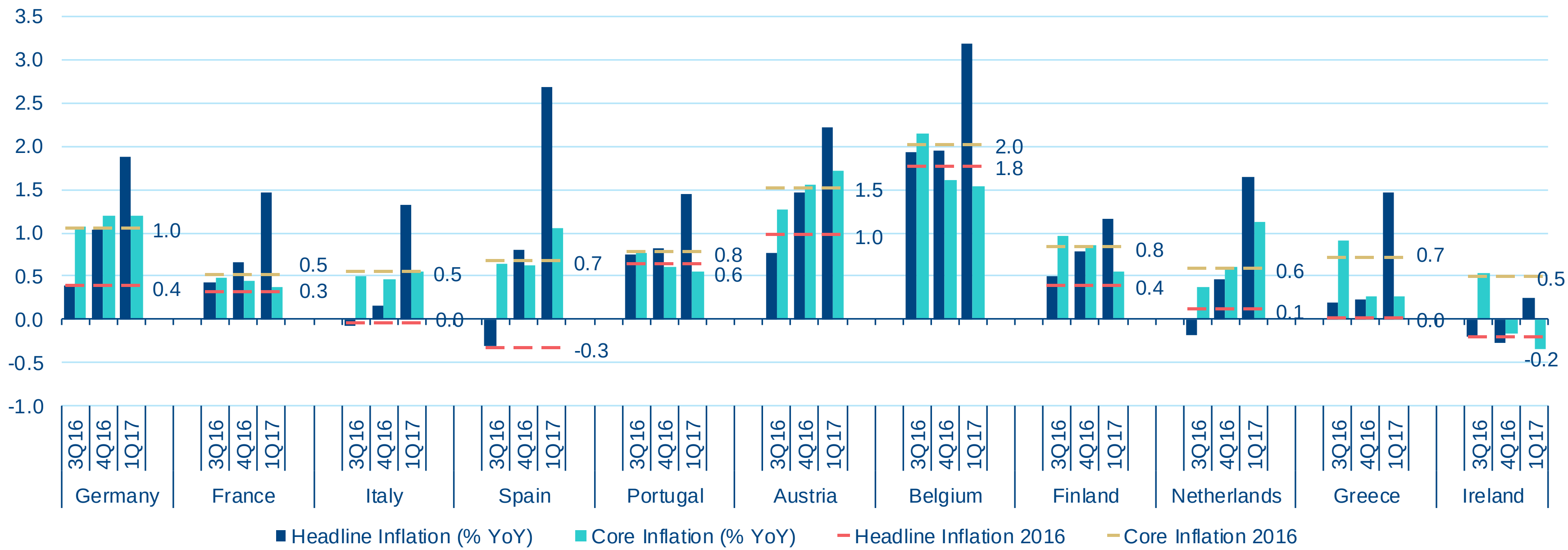
- **HCPI flash inflation slowed by 0.5pp to 1.5% YoY** (Feb: 2.0%) in March, driven by lower increases in both energy (7.3% YoY after 9.3% in February) and fresh food (3% after 5.3%)

- But also some moderation in **core inflation (0.7% after 0.9% YoY)** due to seasonal factors
- Nonetheless, inflation both headline and core are **expected to increase again next month**

ECONOMIC DEVELOPMENTS

Beyond volatility in recent months and energy base effects, core inflation remains subdued across countries

HEADLINE AND CORE INFLATION
(%YoY)



- By country, **HCPI inflation moderated in all core countries** in March except in **France** where inflation remained steady at 1.4% YoY: **Germany** (1.5% after 2.2% YoY), **Italy** (1.3% after 1.6% YoY) and **Spain** (2.1% after 3.0% YoY).

Source: Eurostat and BBVA Research

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Updated forecasts:
A more upbeat outlook, but still surrounded by (political) risks

APRIL 2017

UPDATED FORECASTS

Growth drivers for the eurozone

Gradual improvement in global demand along with a weak euro

Industrial recovery on track with positive underlying signs taking root. Slightly more upbeat outlook for investment

Supportive economic policies: accommodative monetary stance and non-restrictive fiscal policies

Resilience of both confidence and domestic drivers despite of higher (political) uncertainty

Higher commodity prices are pushing up inflation, adding pressure on interest rates and on private consumption

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

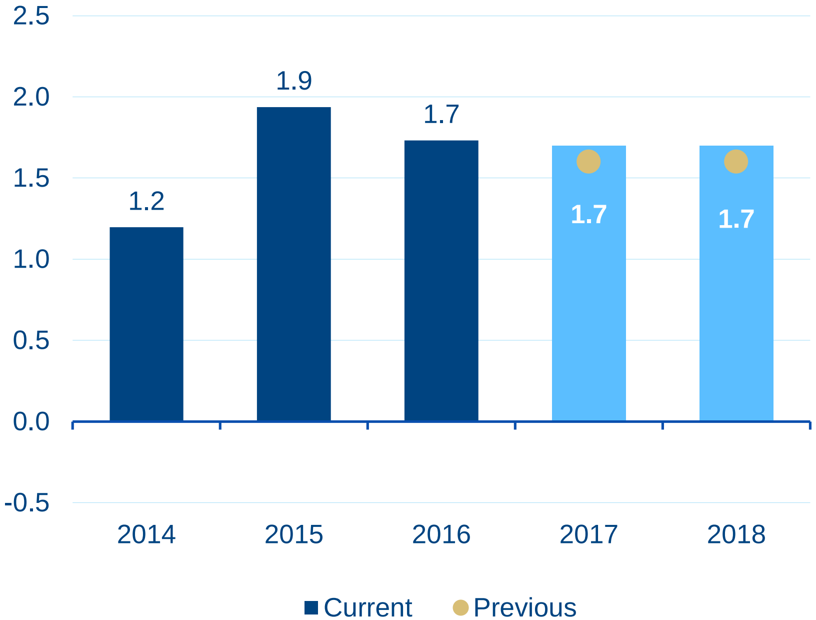
Unresolved problems (Greece, Italy…)

Hard Brexit

UPDATED FORECASTS

Eurozone: a slight upward revision to GDP growth in 2017-18 in spite of a rousing political agenda

GDP GROWTH AND FORECAST
(%)



- **Domestic demand should moderate but continue to be the main support for growth,** still relying on accommodative monetary policy and, in a lesser extent, fiscal policy

Source: Eurostat and BBVA Research

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016	2017 (f)	2018 (f)
Real GDP	**1.9**	**1.7**	**1.7**	**1.7**
Private consumption	1.8	1.9	1.4	1.4
Public consumption	1.3	1.8	1.2	1.0
Investment	3.0	2.5	2.5	3.0
Domestic demand (cont. pp)	**1.7**	**1.9**	**1.6**	**1.5**
Exports	6.3	2.7	3.9	3.5
Imports	6.3	3.4	4.0	3.6
Net exports (cont. pp)	**0.2**	**-0.2**	**0.1**	**0.1**
Current account (% GDP)	3.2	3.3	3.0	2.9
Budget balance (% GDP)	-2.1	-1.9	-1.7	-1.4
HICP (avg. %YoY)	0.0	0.2	1.8	1.6

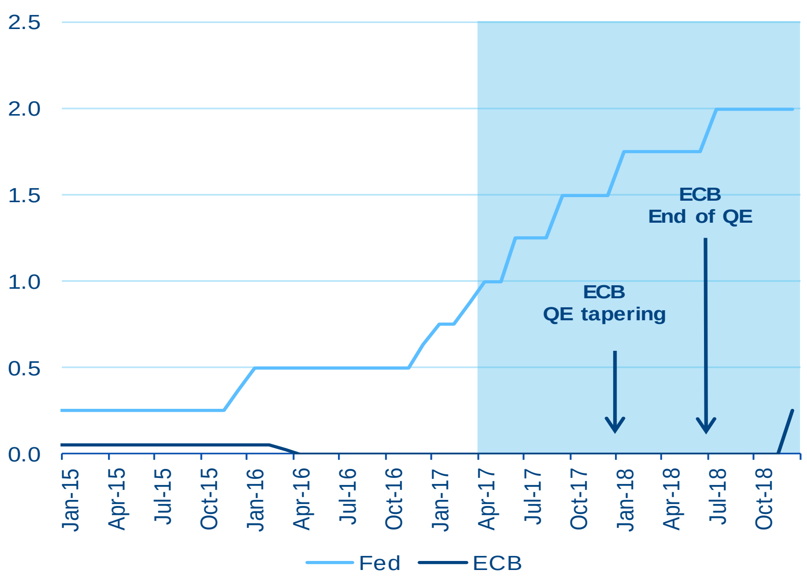
- **A higher contribution from external sector is behind the more positive outlook for 2017-18**

Source: Eurostat and BBVA Research

UPDATED FORECASTS

The ECB is to start discussing about the exit strategy, but very cautiously, contrasting with the Fed's normalization process

FED AND ECB INTEREST RATE
(pb)



- **Changes in the ECB monetary policy stance seem to be premature**
  - **Carefully monitoring core inflation developments,** although pressures should remain subdued for now
  - **Tappering** talks likely to arise by Summer while **communication strategy will be key**
  - We still expect the **end of QE by around mid-2018,** with slower purchases in early-2018 **and the first rate hike by December 2018**
- **The Fed** hiked interest rates (ahead than expectations) maintaining its gradual approach unchanged

Source: Fed, ECB and BBVA Research

UPDATED FORECASTS

Central banks are moving towards normalization: Where are we?

	Tapering (start - end of QE)	Rates hike (ongoing)	Balance sheet (to start)
Fed	Dec 2013 – Oct 2014	Dec 2015 **(+75 pbs up to now)**	When, 2018? How fast?
ECB	1H 2018	Dec 2018	--

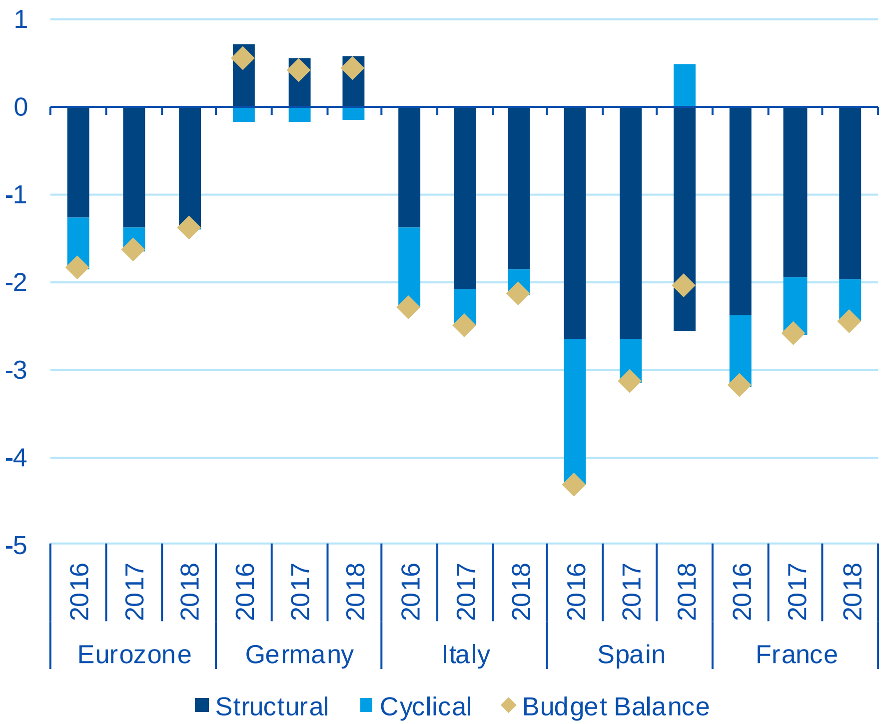
Communication strategy key to a smooth transition
(lessons from the "*taper tantrum*")

Source: Fed, ECB and BBVA Research

UPDATED FORECASTS

Non-restrictive fiscal polices in the eurozone, but with heterogeneity across countries

FISCAL BALANCE: STRUCTURAL AND CYCLICAL
(% GDP)



- **The improvement in fiscal balances** for 2017-18 would be **driven mainly by the cyclical recovery**
- Fiscal policy **slightly expansionary in the eurozone as a whole, Germany and Italy** in 2017
- **Neutral** fiscal policy **in Spain**
- **The exception is France**, as about half of the fiscal consolidation planned for this year would be the result of **discretional measures of about 0.3pp of GDP**

Source: Eurostat, Stability and Convergence Programs and BBVA Research

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UPDATED FORECASTS

Germany: improved external demand outlook somewhat offsetting the moderation of consumption in 2017

MAIN MACROECONOMIC INDICATORS

(%YoY, %GDP)

	2015	2016	2017 (f)	2018 (f)
Real GDP	**1.5**	**1.8**	**1.7**	**1.6**
Private consumption	1.9	1.8	1.4	1.3
Public consumption	2.8	4.0	2.3	1.5
Investment	1.1	2.1	2.0	2.6
Domestic demand (cont. pp)	**1.3**	**2.1**	**1.6**	**1.6**
Exports	4.6	2.4	3.5	3.2
Imports	5.0	3.6	3.9	3.7
Net exports (cont. pp)	**0.1**	**-0.3**	**0.1**	**0.0**
Current account (% GDP)	8.3	8.5	7.6	7.0
Budget balance (% GDP)	0.7	0.6	0.4	0.4
HICP (avg. %YoY)	0.1	0.4	2.0	1.7

- **GDP growth forecast revised slightly upwards from 1.6 to 1.7 for this year,** driven by a positive contribution from the net external sector
- Higher inflation added to only incipient signs of wage pressures should weight over **private consumption moderation in 2017**…
- …while **public expenditure is expected to be more moderate** after last year one-off expenditure linked to immigration
- **Investment to remain still subdued** this year due to political uncertainty

Source: Eurostat and BBVA Research

UPDATED FORECASTS

France: somewhat more resilient than previously expected, but higher uncertainty persists

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016	2017 (f)	2018 (f)
Real GDP	**1.2**	**1.1**	**1.4**	**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	2.7	2.1	2.3
Domestic demand (cont. pp)	**1.5**	**2.0**	**1.6**	**1.6**
Exports	6.0	1.1	3.6	3.5
Imports	6.4	3.7	3.9	3.2
Net exports (cont. pp)	**-0.3**	**-0.9**	**-0.2**	**0.0**
Current account (% GDP)	-0.2	-0.9	-1.3	-1.0
Budget balance (% GDP)	-3.5	-3.2	-2.6	-2.5
HICP (avg. %YoY)	0.1	0.3	1.5	1.4

- **GDP growth in 2017 revised slightly upwards** from 1.3% to 1.4% for 2017 driven by better incoming data, in spite of political uncertainty due highly polarized elections
- **Private consumption is expected to decelerate to some extent** in response to both higher inflation and lower steam from confidence figures
- **Restrictive fiscal measures** in 2017 should drag public expenditures
- **Exports recovery consolidates,** supported by recovery in global demand. Net exports would weigh less on GDP growth but also will support investments in those sectors

Source: Eurostat and BBVA Research

UPDATED FORECASTS

Italy: both political and financial vulnerabilities remain as a drag to a faster recovery

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016	2017 (f)	2018 (f)
Real GDP	**0.7**	**1.0**	**1.0**	**1.2**
Private consumption	1.6	1.3	0.9	1.0
Public consumption	-0.7	0.6	0.1	0.4
Investment	1.4	3.1	3.0	2.6
Domestic demand (cont. pp)	**1.2**	**1.1**	**1.0**	**1.1**
Exports	4.1	2.6	3.7	3.2
Imports	6.7	3.1	3.9	2.9
Net exports (cont. pp)	**-0.5**	**-0.1**	**0.0**	**0.1**
Current account (% GDP)	1.4	2.6	2.6	2.4
Budget balance (% GDP)	-2.6	-2.3	-2.5	-2.2
HICP (avg. %YoY)	0.1	-0.1	1.6	1.4

- **Political uncertainty and financial sector vulnerability to continue** to be a drag to the recovery
- **Overall, consumption should moderate** due to higher inflation, although partly offset by policy measures to support job growth
- **Exports to benefit** from improved global demand …
- … that would support **a robust growth in investment**

Source: Eurostat and BBVA Research

UPDATED FORECASTS

Spain: cyclical factors support a milder than expected deceleration

MAIN MACROECONOMIC INDICATORS
(%YoY, %GDP)

	2015	2016	2017 (f)	2018 (f)
Real GDP	**3.2**	**3.2**	**3.0**	**2.7**
Private consumption	2.9	3.2	2.5	2.4
Public consumption	2.0	0.8	1.0	2.0
Investment	6.0	3.1	3.3	4.5
Domestic demand (cont. pp)	**3.3**	**2.8**	**2.3**	**2.6**
Exports	4.9	4.4	5.8	5.0
Imports	5.6	3.3	4.2	5.2
Net exports (cont. pp)	**-0.1**	**0.4**	**0.7**	**0.1**
Current account (% GDP)	1.4	1.9	1.8	1.5
Budget balance (% GDP)	-5.0	-4.3	-3.1	-2.1
HICP (avg. %YoY)	-0.5	-0.2	2.1	1.9

- **Upward GDP growth revision** to 3.0% in 2017 (from 2.7%) due to both positive incoming data from external sector, employment and sings of recovery in residential investment …
- …nonetheless **overall domestic demand continues to decelerate,** driven by both household consumption and investment in machinery and equipment
- **Fiscal policy will shift to be neutral** during 2017-18
- **Exports recovery continues** in spite of Brexit

Source: Eurostat and BBVA Research

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APRIL 2017

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