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BBVA Research

Eurozone Economic Watch

April 2018



Eurozone: solid growth and broadly unchanged projections, with protectionist risks

- **Confidence has weakened in 1Q18** since the extraordinary high mood in late 2017. Bad weather and supply-chain constraints could have weighed on recent figures. Protectionism fears are not likely to be much reflected yet in these figures. Some leading indicators from surveys, such as employment or backlogs of work, remain positive.
- **Hard data softened again in February** after the good performance in the second half of 2017, suggesting also some moderation in activity, but it is too early to detect a reversal in the trend, especially without significant changes in fundamentals in recent months. Both retail sales and industrial production slowed down, but **the recovery in the labour markets and foreign trade continued**.
- Reflecting this, our **MICA-BBVA model** estimates some moderation in GDP growth at around **0.5% QoQ in 1Q18** (from slightly upward revised 0.7% in 4Q17).
- Both domestic and global **fundamentals remain strong although stabilizing**: (i) fiscal and monetary policy will continue to be expansionary (the latter decreasing only gradually); (ii) global growth should continue to support foreign trade; and (iii) the narrowing labour market slack and still low inflation should continue to support consumption.
- **We maintain our baseline scenario broadly unchanged**, with a GDP growth forecast of 2.3% for 2018 (revised up by 0.1pp) while keeping a gradual slowdown to 1.8% for next year.
- Core inflation resumed the gradual upward trend in 1Q18, while the easing of the headline rate was driven by non-core components. **Headline inflation is projected to hover around 1.5% YoY over next year and to increase gradually afterwards** (1.5% in 2018 and 1.6% in 2019) driven by core (1.3% in 2018 and 1.6% in 2019).
- **Risks to our baseline scenario are coming mostly from increasing protectionism and domestic politics**.



01

Economic developments

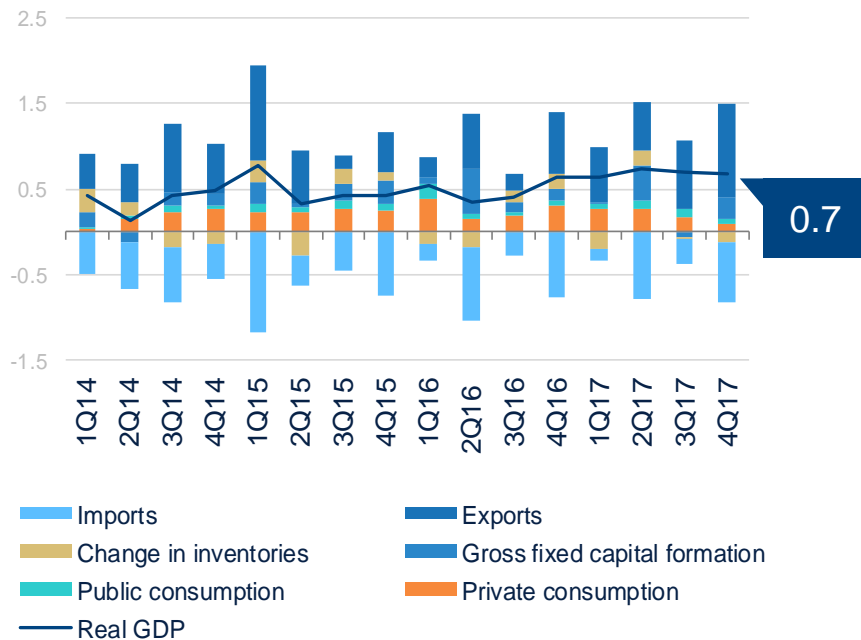
Growth is still strong and balanced but data shows early signs of moderation

A slight moderation from high growth levels seems to be taking place in 1Q18

■ The quarterly GDP growth figure of 4Q17 was revised upwards by 0.1pp to 0.7% QoQ. In this context, our MICA-BBVA model points to a quarterly GDP growth of 0.5% QoQ in 1Q18, slightly lower than previously forecasted

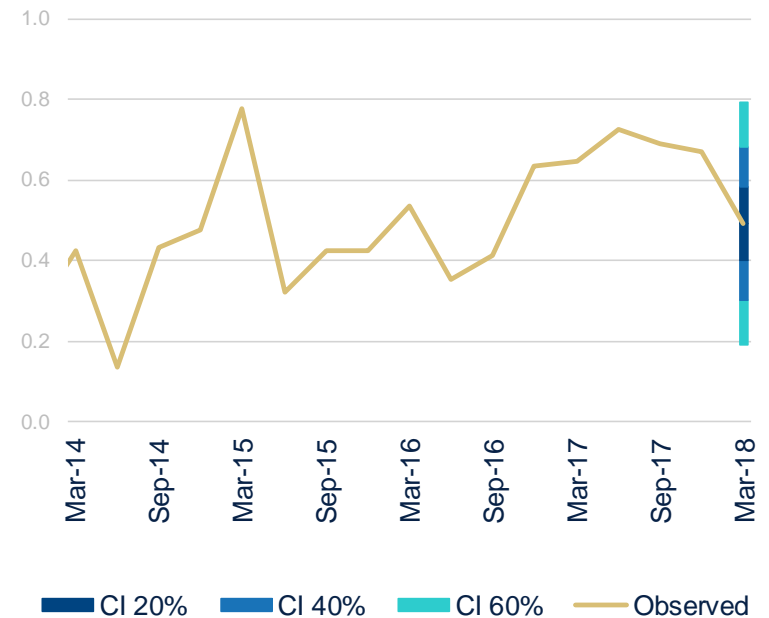
GDP, contribution by components

(%QoQ, pp)



GDP and MICA forecasts

(%QoQ)

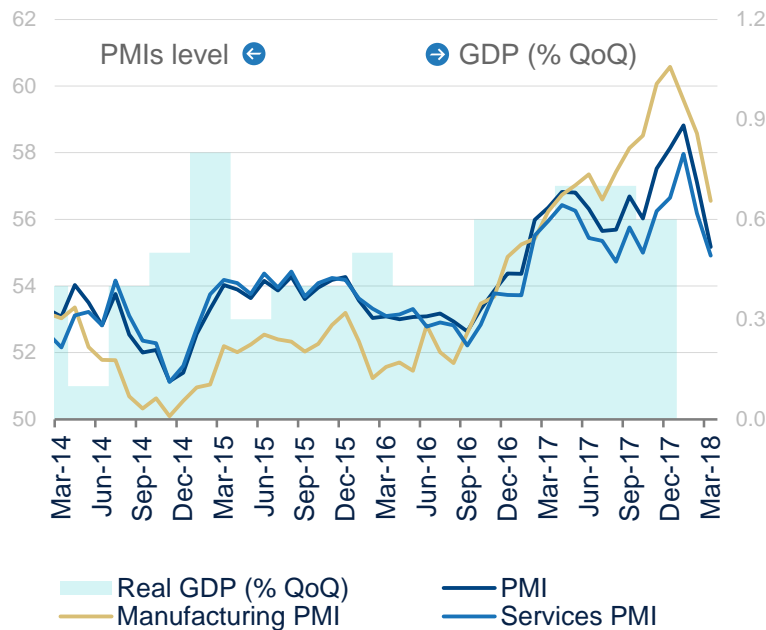


Optimism has weakened in 1Q18 since the extraordinary high mood in late 2017

■ Despite that sentiment indicators have extended the downward trend from high levels, the reduced optimism is still consistent with a robust growth pace in early 2018 and in coming quarters

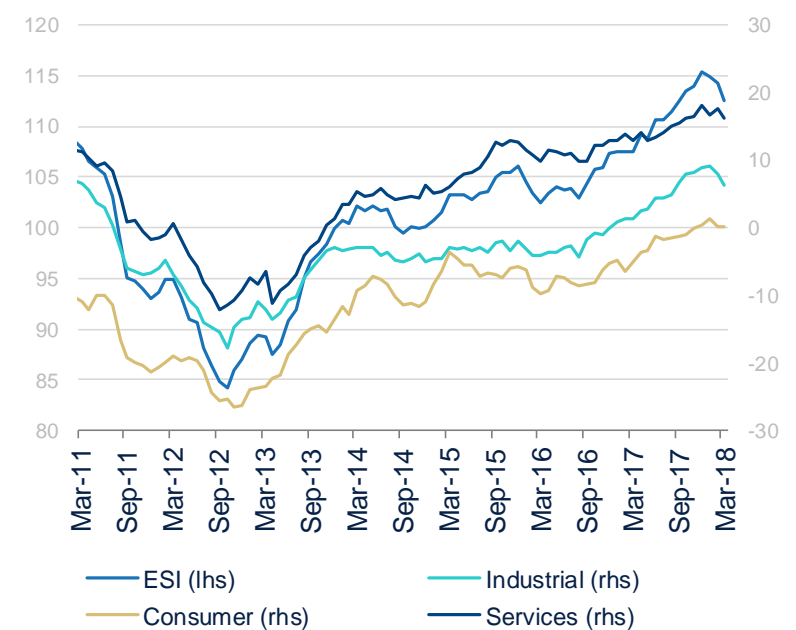
PMI and GDP

(level, %QoQ)



EC confidence survey

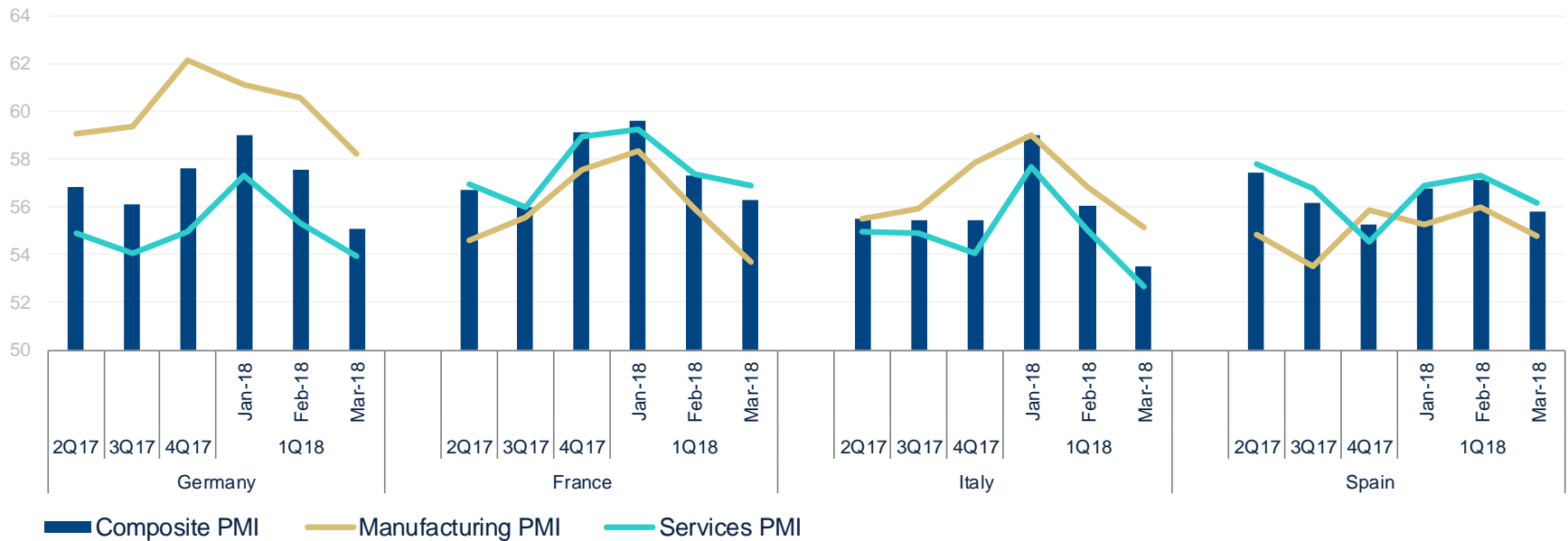
(level)



In both manufacturing and services PMIs, high confidence continued to soften across major countries during March

- Bad weather and supply-chain constraints during a prolonged winter could have weighed on recent figures. Nonetheless, some components from surveys, such as employment, remain at high levels

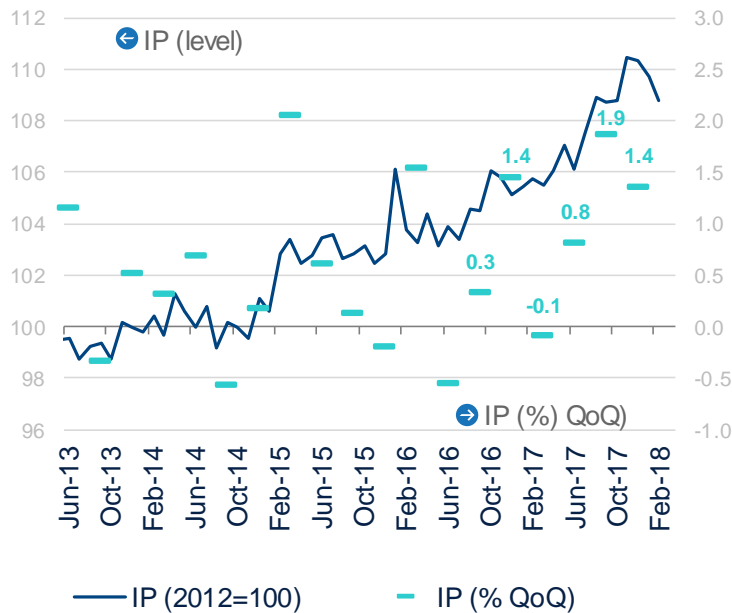
PMI survey (level)



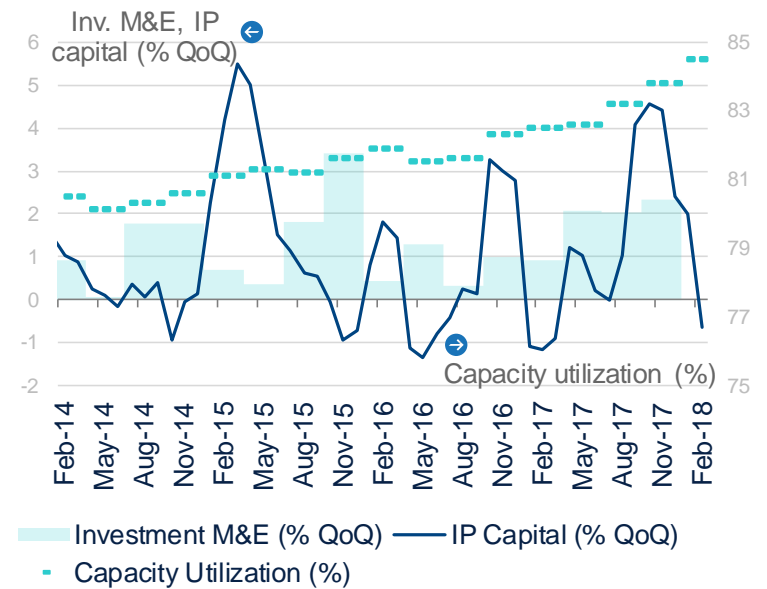
Industrial output growth moderates further in February

■ Production declined again in February (-0.8% MoM), but the weakness in early 2018 took place after a high dynamism in 2H17 (around 1.6% QoQ on average)

Industrial production (level, %QoQ)



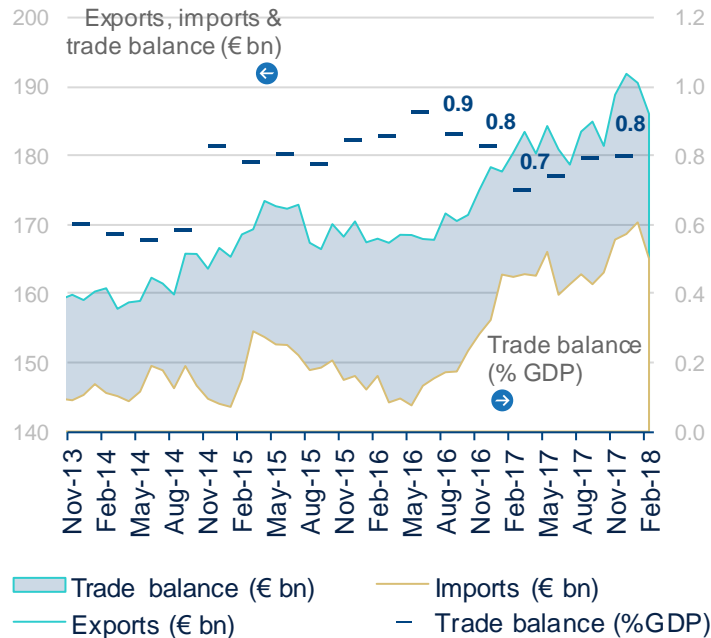
IP capital equipment, investment in M&E and capacity utilization (%QoQ, %)



Exports are still growing but at a more moderate pace in 1Q18, while imports seem to be declining

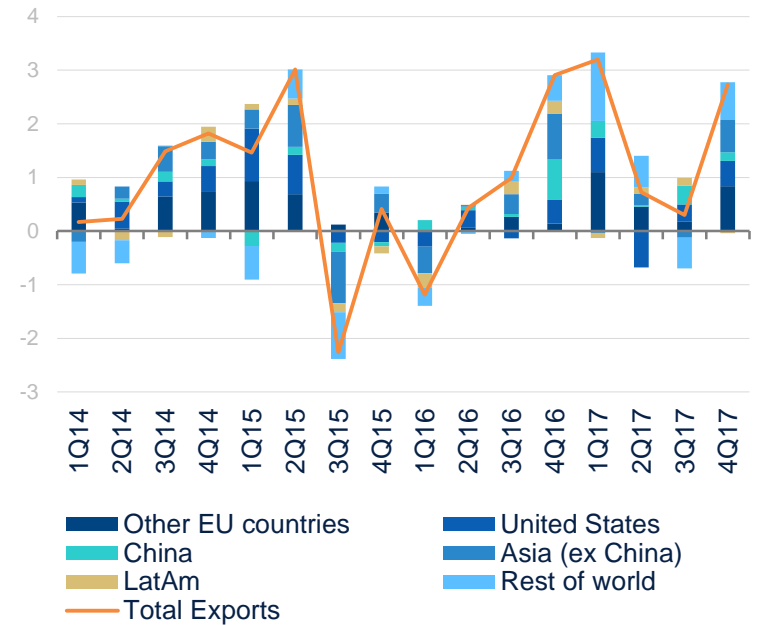
Trade balance

(€ bn, %GDP)



Exports by destination

(%QoQ, pp)

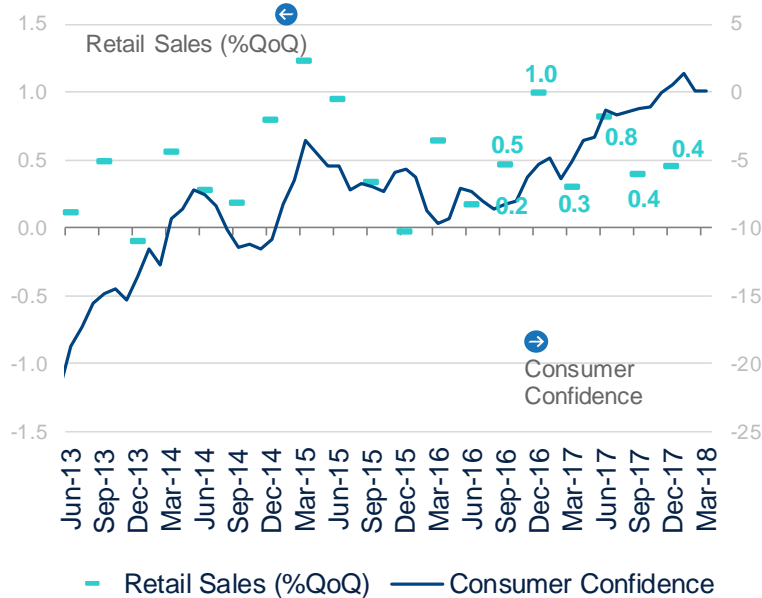


Retail sales softened at the start of the year despite strong consumer confidence

- Consumer confidence gains has stabilized at high levels in 1Q18 despite increased market volatility and political uncertainty

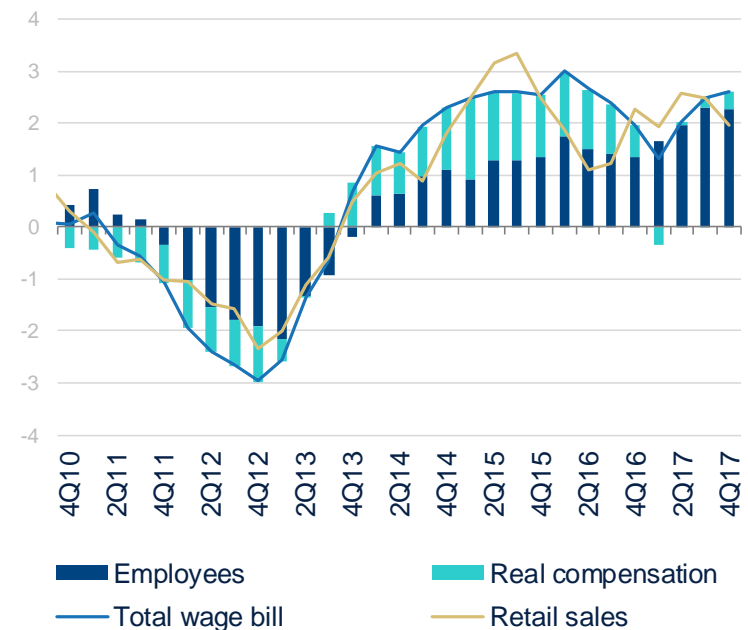
Retail sales and consumer confidence

((%QoQ, pts)



Retail sales and total wage bill

(%YoY, pp)

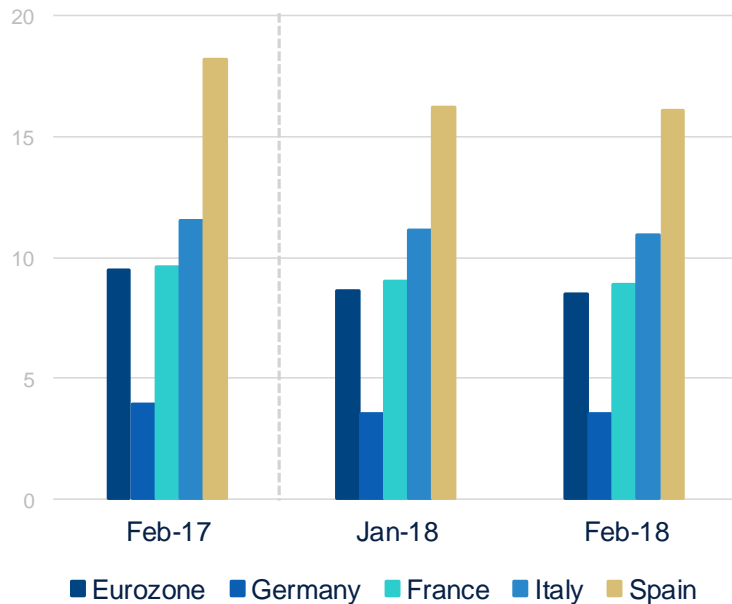


The labour market slack continued to narrow in 1Q18

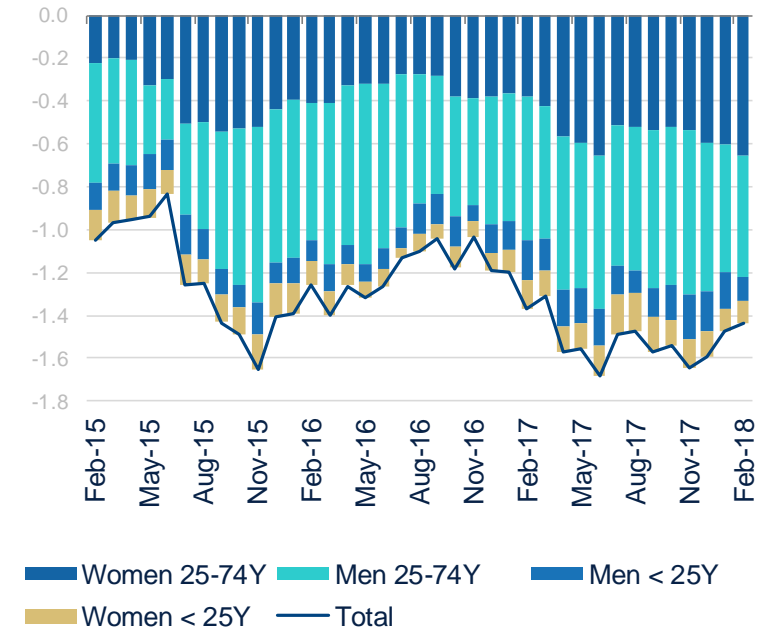
■ The unemployment rate declined to 8.5% in February, which is 1% lower than a year ago

■ The decline in unemployment is concentrated in the group of prime-aged men

Unemployment rate by country (%)



Annual unemployment change by gender & age (millions)

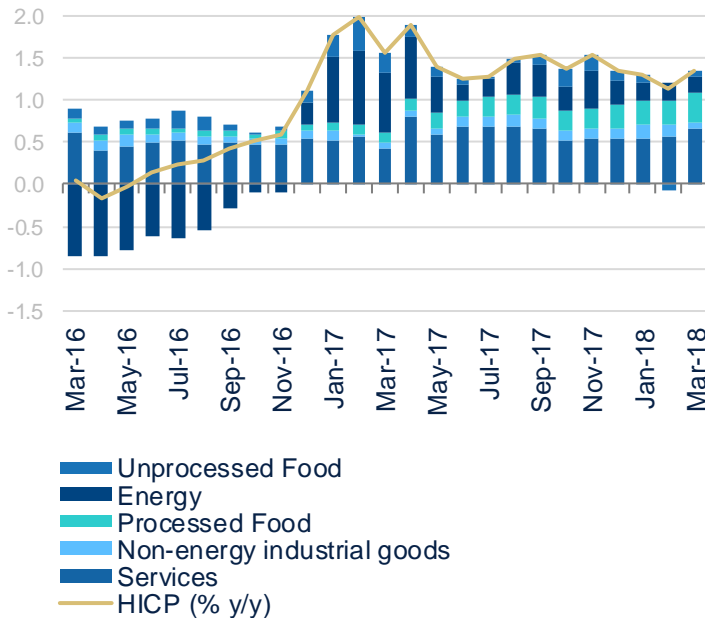


Headline inflation increased in March pushed by foods while core measure remained broadly stable

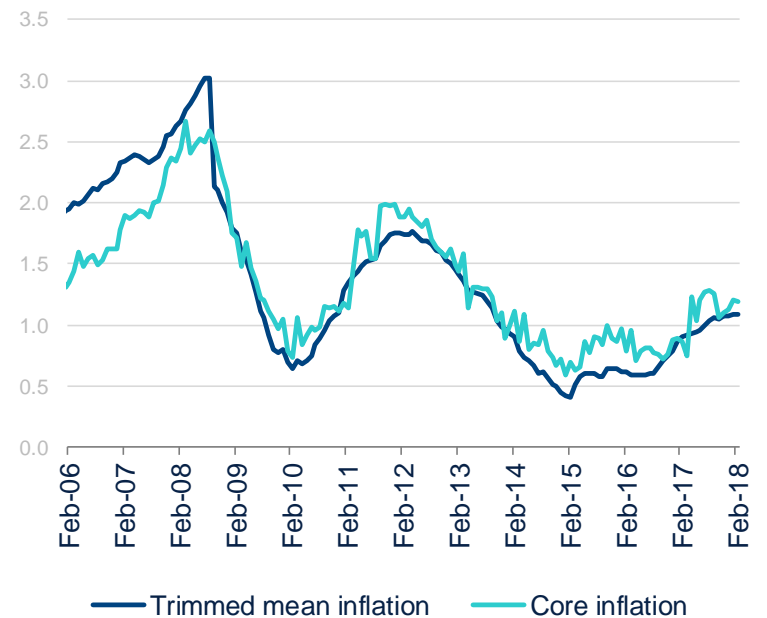
■ HICP Inflation increased to 1.3% YoY (+0.2pp) driven mostly by unprocessed food

■ Core inflation picked-up a bit to 1.3% YoY, still showing a gradual recovery

Inflation and contribution of components
(%YoY, pp)

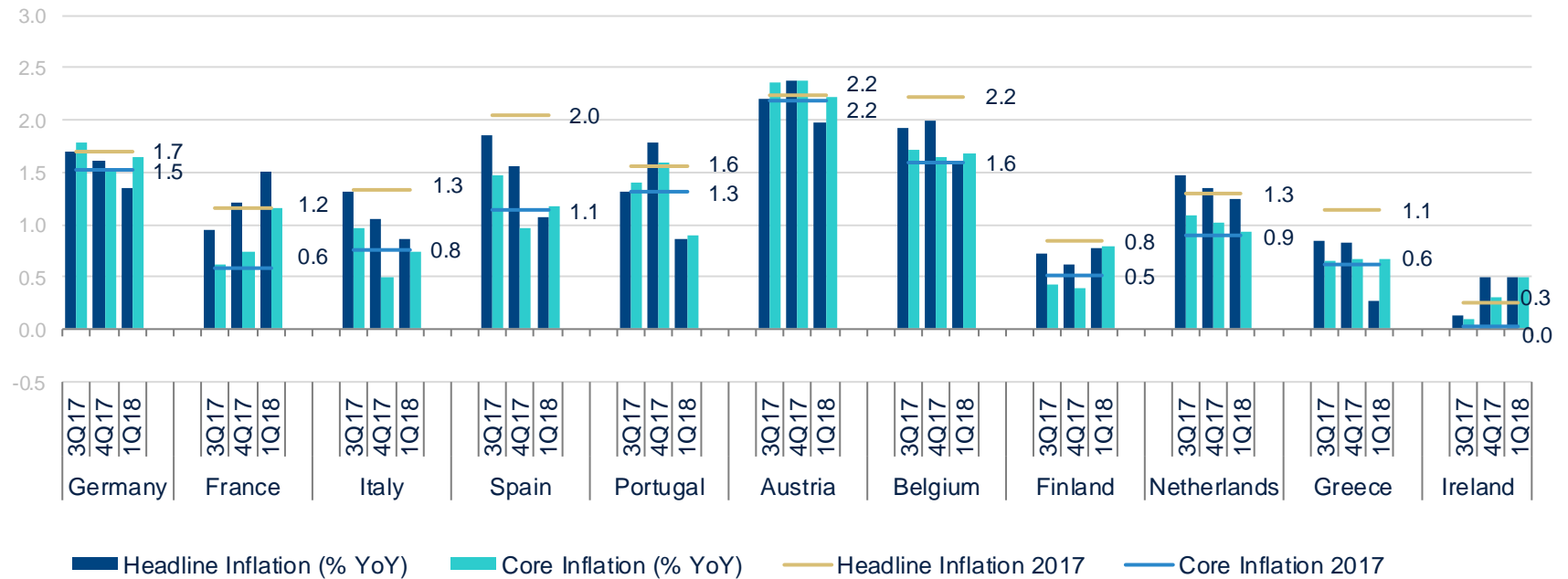


Core and trimmed-mean inflation
(%YoY)



Core inflation has increased in most countries in early 2018

Headline and core inflation (%YoY)





02

Updated forecasts

Solid growth but moderating in the
forecast horizon

Growth drivers for the Eurozone



Resilient domestic factors

- Narrowing labour market slack
- Profit gains still on track
- Favourable lending conditions



Strong global demand

- Positive spillovers from higher US growth
- China's good performance



Some setbacks from market volatility

- Protectionist narratives and political stalemate could weigh on confidence



Still supportive economic policies

- Very gradual ECB's exit added to slightly expansionary fiscal policy



Inflation remains weak and increasing slowly

- Inflationary pressures remain contained, reinforced by the euro appreciation
- Wage growth still subdued



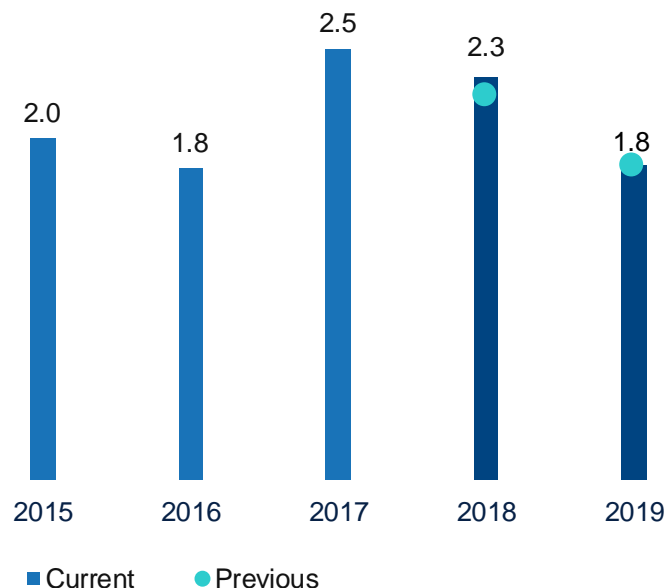
Global risks intensify

- Higher risk of possible escalation of protectionist measures
- Domestic risks, mostly from politics

Slightly more upbeat outlook in the short-term in the EZ, but a gradual slowdown ahead is still expected

- Minor upward revision in 2018 GDP growth (+0.1pp to 2.3%) to account for stronger exports
- A gradual slowdown is still expected over the forecast horizon with growth reaching a plateau
- Despite a slightly lower contribution from domestic demand, the investment recovery remains on track, adding to resilient consumption
- Still subdued inflationary pressures while core inflation resumed its gradual upward trend in 1Q18

Eurozone GDP growth and forecast (%)



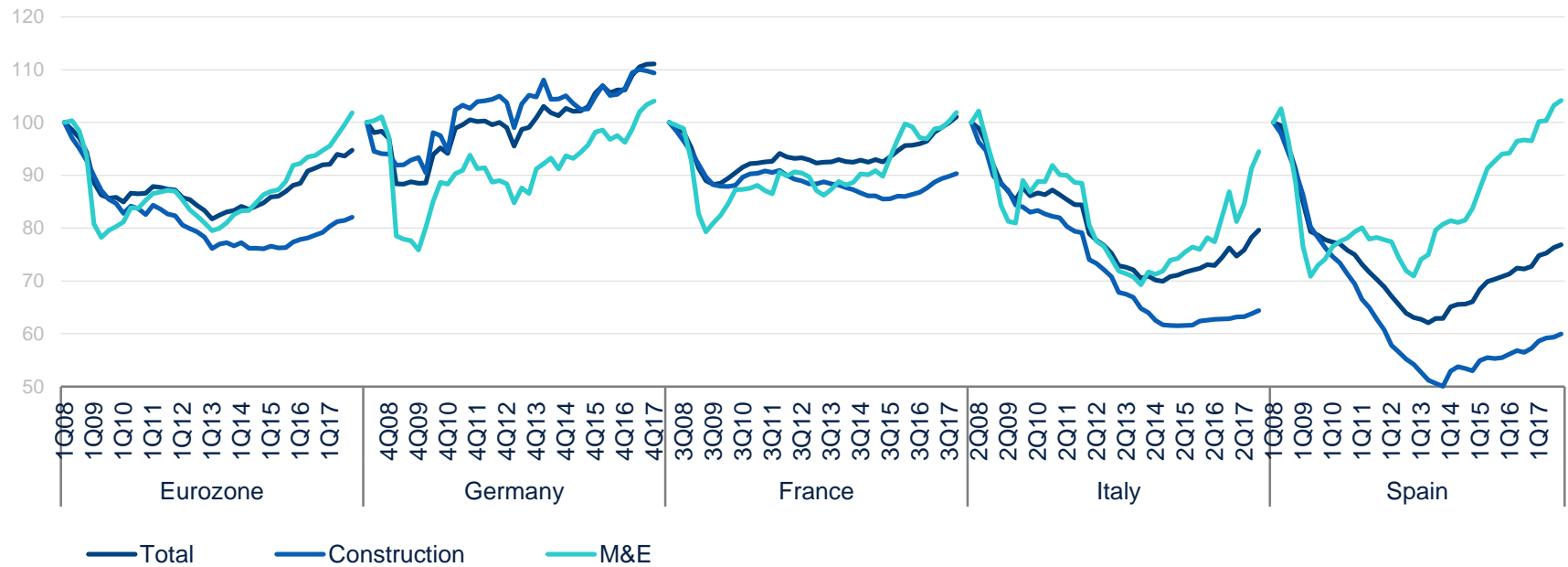
Main macroeconomic indicators (% YoY, %GDP)

	2016	2017 (e)	2018 (f)	2019 (f)
Real GDP	1.8	2.5	2.3	1.8
Private consumption	1.9	1.7	1.6	1.6
Public consumption	1.8	1.2	1.3	1.1
Investment	4.5	3.2	3.5	3.0
Domestic demand (cont. pp)	2.3	1.9	1.9	1.8
Exports	3.4	5.4	5.1	4.0
Imports	4.8	4.5	4.6	4.2
Net exports (cont. pp)	-0.5	0.6	0.4	0.0
Current account (% GDP)	3.4	3.5	3.5	3.3
Budget balance (% GDP)	-1.5	-1.1	-0.8	-0.6
HICP (avg. %YoY)	0.2	1.5	1.5	1.6

Investment remains on track, slowly regaining pre-crisis levels

Investment by country

(1Q18=100)

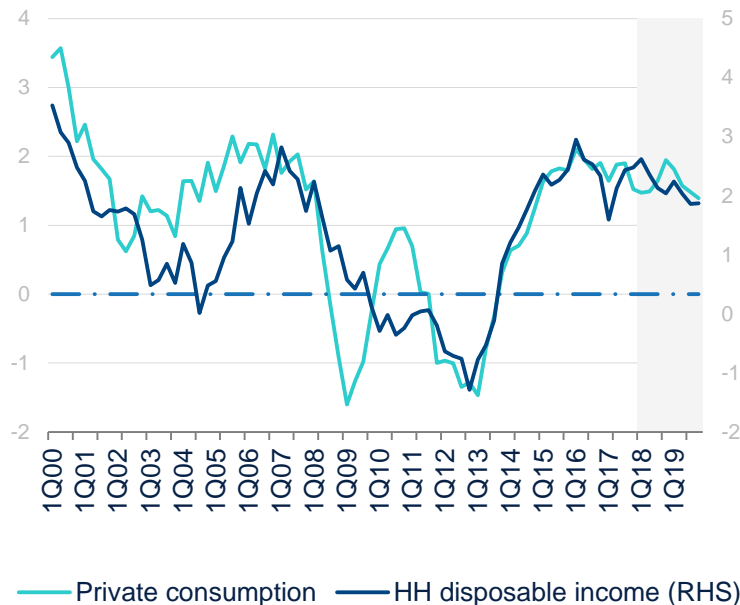


Solid consumption in 2018-19 despite still moderate wage growth

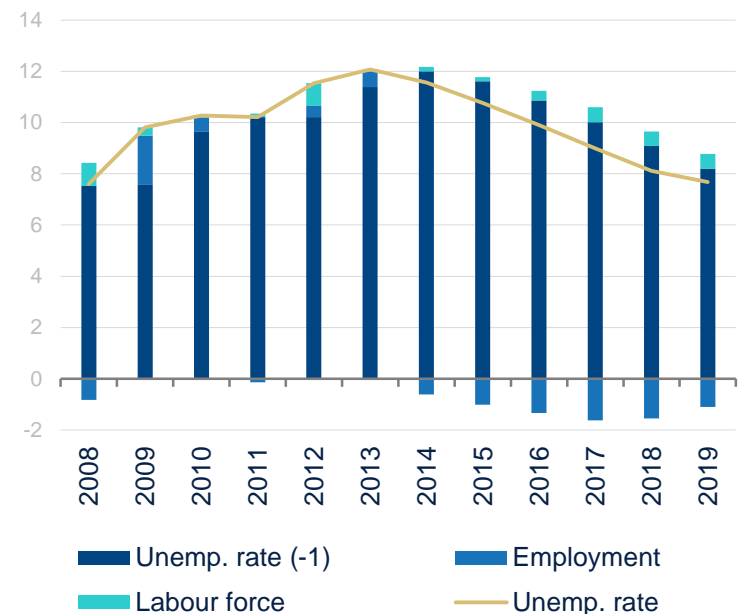
- Private consumption has shown **strong growth** and adds to buoyant confidence levels
- Real **disposable income** to slightly moderate on higher inflation expectations

- Unemployment rate **expected to keep its downward trend**

Private consumption and real labour income (% YoY)

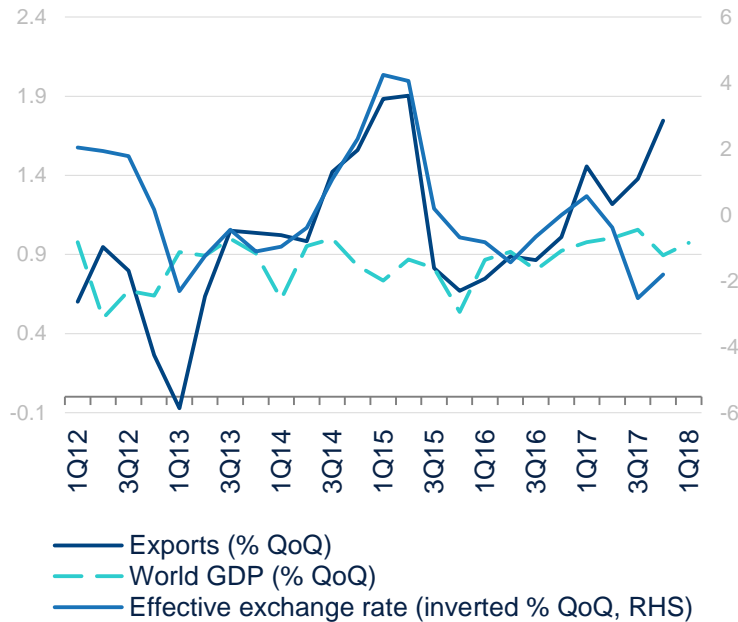


Unemployment rate and contribution (% , pp)

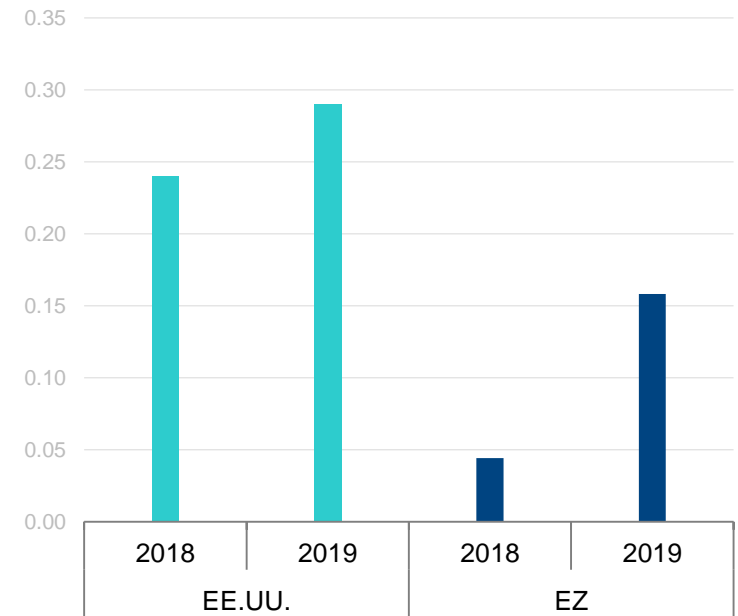


Upward revision of US growth forecasts could add further support to global demand, while the impact from the euro strength is still limited

Exports, EURUSD and World GDP

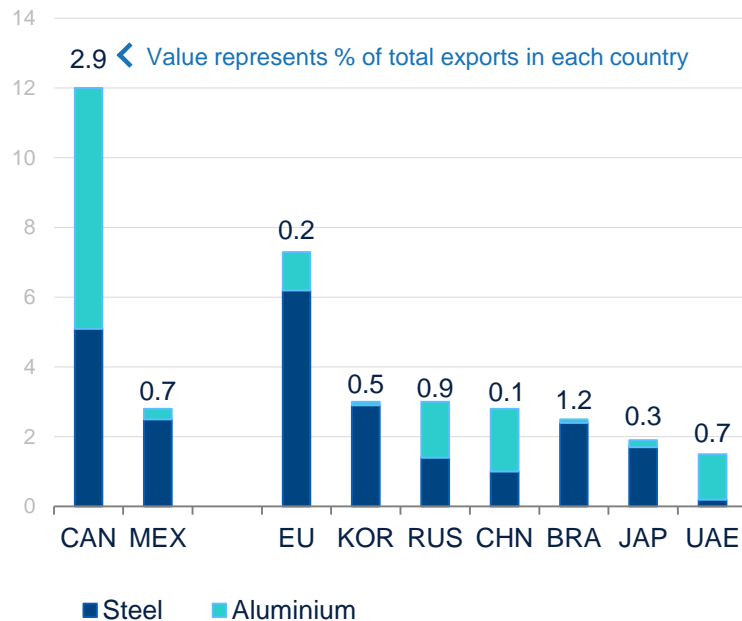


Effect of higher US growth on Eurozone GDP growth (pp)



The risk of a protectionist escalation creates uncertainty about the global economic outlook

Exports, EURUSD and World GDP



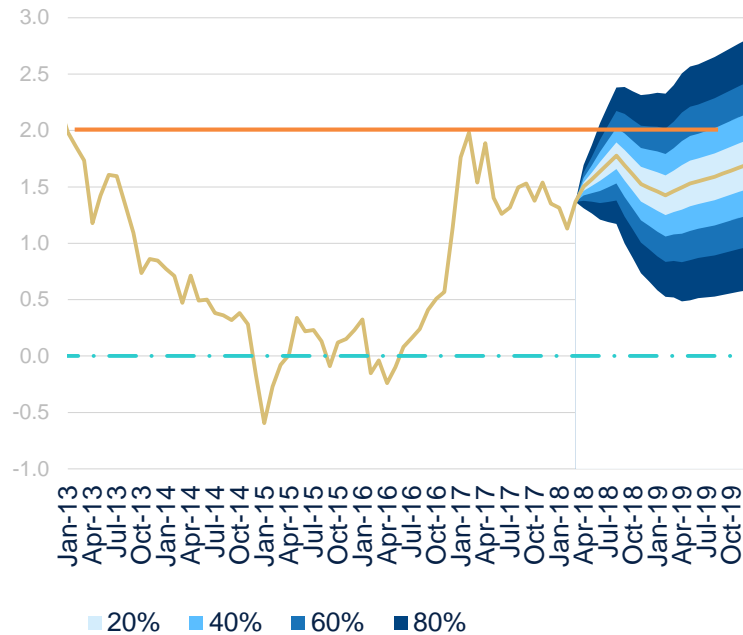
- US tariffs on steel and aluminum have a small direct impact on activity:
 - They represent only a small share of total exports
 - Exemption for many countries until May
 - The greatest negative impact may come from indirect effects and possible reaction of the countries concerned
- The mutual tariff increase between the US and China (25%, 50bn USD in 2017):
 - Larger effect: 38% exports to China (3% of the total US exports) and 11% of exports to the US (2% of the total chinese exports)
 - They can only be the beginning of a major escalation
- EU faces a potential loss of USD2.6bn (0.1% of good exports) according to US Commerce Department estimation

Headline inflation to hover around 1.5% over next year and to increase gradually afterwards driven by core components

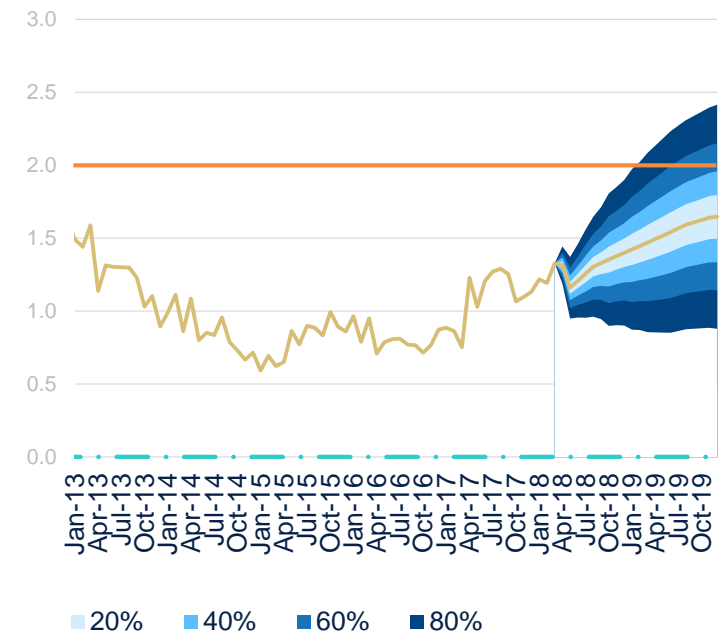
■ Core inflation resumed the gradual upward trend in 1Q18, as expected, while the easing of the headline rate was driven by non-core components

■ Broadly unchanged inflation projections: more evident gradual increase in core inflation from 2019 onwards

HICP headline inflation and forecast (% YoY)



HICP core inflation and forecast (% YoY)



The ECB is making progress on the QE exit, but avoiding tensions

QE



The **QE will end in 2018**

- Monthly purchases of assets (30bn EUR) up to September
- Purchases withdrawal between September and December

Interest rates



As we approach the end of QE, the **focus shifts to the rate hikes:** when and at what pace

But the **ECB will remain in debt markets:** reinvestment of maturities

The **challenge** for the ECB is to **manage the interest rate expectations** (*forward guidance*)

Key issues in QE exit:



Long interest rates and risk premium



Exchange rate (Euro)



Expectations on interest rate hikes

Germany: solid growth based on the strength of domestic demand

Main macroeconomic indicators (% YoY, %GDP)

	2016	2017 (e)	2018 (f)	2019 (f)
Real GDP	1.9	2.5	2.4	1.8
Private consumption	1.9	2.1	1.7	1.6
Public consumption	3.7	1.6	1.7	1.6
Investment	2.9	3.9	3.8	3.1
Domestic demand (cont. pp)	2.2	2.3	2.1	1.9
Exports	2.4	5.3	6.5	4.1
Imports	3.8	5.6	6.6	4.8
Net exports (cont. pp)	-0.4	0.2	0.4	0.0
Current account (% GDP)	8.5	8.1	8.3	7.9
Budget balance (% GDP)	0.8	0.9	1.0	1.0
HICP (avg. %YoY)	0.4	1.7	1.7	1.8

- Recent data suggest that **economic activity is still favoured by external demand**
- GDP growth **forecasts are kept unchanged**, characterized by a gradual deceleration going forward
- Private **consumption will moderate** due to a tighter labour market, the gradual upturn of inflation and softer confidence
- The still **positive global outlook** will continue to support strong trade figures and investment
- Public expenditure** expected to **grow steadily** given an unchanged fiscal policy stance
- Local risks** coming mostly from a **weakened government coalition** that could weigh on the potential reform agenda

France: growth revised up thanks to the support of net exports

Main macroeconomic indicators

(% YoY, %GDP)

	2016	2017 (e)	2018 (f)	2019 (f)
Real GDP	1.1	2.0	2.0	1.6
Private consumption	2.1	1.3	1.6	1.5
Public consumption	1.2	1.6	1.4	1.2
Investment	2.7	3.8	3.7	2.7
Domestic demand (cont. pp)	1.9	2.3	2.0	1.6
Exports	1.9	3.3	4.9	3.5
Imports	4.2	4.1	4.3	3.2
Net exports (cont. pp)	-0.8	-0.4	0.0	0.0
Current account (% GDP)	-0.9	-1.2	-1.0	-0.9
Budget balance (% GDP)	-3.4	-2.8	-2.6	-2.6
HICP (avg. %YoY)	0.3	1.2	1.3	1.5

- Exports and investments surprised to the upside at the end of 2017
- We revised up GDP growth in 2018 to 2.0% (+0.1pp), while keeping a view of growth moderation in 2019
- Private consumption to benefit from reduced labour market slack, high confidence and low inflation
- Reforms will continue to spur investment and prolong the positive business cycle
- Nonetheless, imports' growth will partly offset the higher contributions of exports coming from the recovery in global trade
- The reform agenda and fiscal consolidation are on track but could be delayed by the risk of heightened social discontent

Italy: the growth gap with the Eurozone persists despite a better performance

Main macroeconomic indicators

(% YoY, %GDP)

	2016	2017 (e)	2018 (f)	2019 (f)
Real GDP	1.0	1.6	1.5	1.3
Private consumption	1.4	1.4	1.1	1.0
Public consumption	0.6	0.1	0.3	0.4
Investment	3.3	3.9	4.2	2.2
Domestic demand (cont. pp)	1.3	1.4	1.4	1.1
Exports	2.6	6.0	5.0	3.3
Imports	3.8	5.7	5.2	3.1
Net exports (cont. pp)	-0.3	0.2	0.1	0.1
Current account (% GDP)	2.7	3.0	2.8	2.4
Budget balance (% GDP)	-2.5	-2.2	-1.9	-1.6
HICP (avg. %YoY)	-0.1	1.3	1.3	1.6

- Broadly stable growth figures, despite coming somewhat below expectations in 4Q17
- We keep our GDP growth forecasts at 1.5% and 1.3% in 2018 and 2019, respectively
- Investment figures have surprised to the upside and will continue to underpin growth
- Private consumption should gradually moderate, mostly dragged down by higher inflation
- The recovery in global trade will support higher exports dynamism, consolidating a positive contribution from net external demand
- Policy uncertainty and risks of populism remain latent after the elections

Spain: upward revision in growth in spite of the economic policy uncertainty

Main macroeconomic indicators

(% YoY, %GDP)

	2016	2017 (e)	2018 (f)	2019 (f)
Real GDP	3.3	3.1	2.9	2.5
Private consumption	2.9	2.4	2.2	2.0
Public consumption	0.8	1.6	1.7	1.9
Investment	3.3	5.0	4.8	5.4
Domestic demand (cont. pp)	2.5	2.8	2.6	2.6
Exports	4.8	5.0	4.8	6.1
Imports	2.7	4.7	4.2	6.9
Net exports (cont. pp)	0.7	0.3	0.3	-0.1
Current account (% GDP)	1.9	1.7	1.5	1.1
Budget balance (% GDP)	-4.3	-3.1	-2.4	-1.7
HICP (avg. %YoY)	-0.2	2.0	1.5	1.6

- Recent economic data point towards a stronger GDP growth (+0.4pp to 2,9% in 2018 and +0.2pp to 2.5% in 2018)
- Consumption is slowing down gently, but exports and investment show clear signs of recovery
- Uncertainty in Catalonia remains high, but decreasing
- External fundamentals driven by global demand still support a relatively strong recovery
- Political uncertainty, fiscal adjustment and a non inclusive recovery are the main local risk

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