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BBVA Research

Eurozone Economic Watch

July 2018



Eurozone: A shift to more moderate growth with increased downward risks

- **Hard data improved in May but failed to recover from disappointing figures earlier this year.** Retail sales and industrial output suggest a solid growth of both private consumption and investment, but at more moderate pace than in 2H17.
- **Confidence indicators seem to level off up to July and remain resilient despite increasing uncertainty,** pointing to relatively steady growth over the second half of the year. Some leading components, such employment expectations, remain positive, mostly driven by services sector.
- **Our MICA-BBVA model estimates a GDP growth at around 0.4% QoQ in 2Q18 (a stable figure with respect to 1Q18).** All in all, the **eurozone gears towards more moderate but solid growth this year,** supported by the strength of domestic demand after slowing markedly in the first quarter.
- The faster-than-expected slowdown in activity early this year along with increasing uncertainty and higher commodity prices lead us to **revise down GDP growth forecasts by 0.3pp to 2% in 2018 and -0.1pp to 1.7% in 2019.**
 - **Positive growth drivers remain in place.** Fiscal and monetary policy will continue to support domestic demand in addition to improving labour market, while the euro depreciation along with robust global demand will continue to support exports.
 - **But increasing uncertainty could weigh on activity forward.** **Protectionism** measures approved so far have a limited direct effect on activity, but could start dampening confidence and investment. The negative effect could be significant if the announced protectionist measures were implemented and other channels (confidence and financial) kick in.
- **Headline inflation could hover slightly above 2% in the short-run** driven by energy and food prices, **but core inflation remains broadly stable at low levels.**
- Higher oil prices and a weaker euro lead us to **revise up headline inflation forecasts by 0.2pp in 2018-19 to 1.7% and 1.8%, respectively.** Nascent inflationary pressures should support our view of **gradual upward trend in core inflation in coming months** (unchanged forecast at 1.1% in 2018 and 1.6% in 2019).
- **Downward risks to this scenario have intensified** and come mostly from a **full blown trade war and domestic politics.**



01

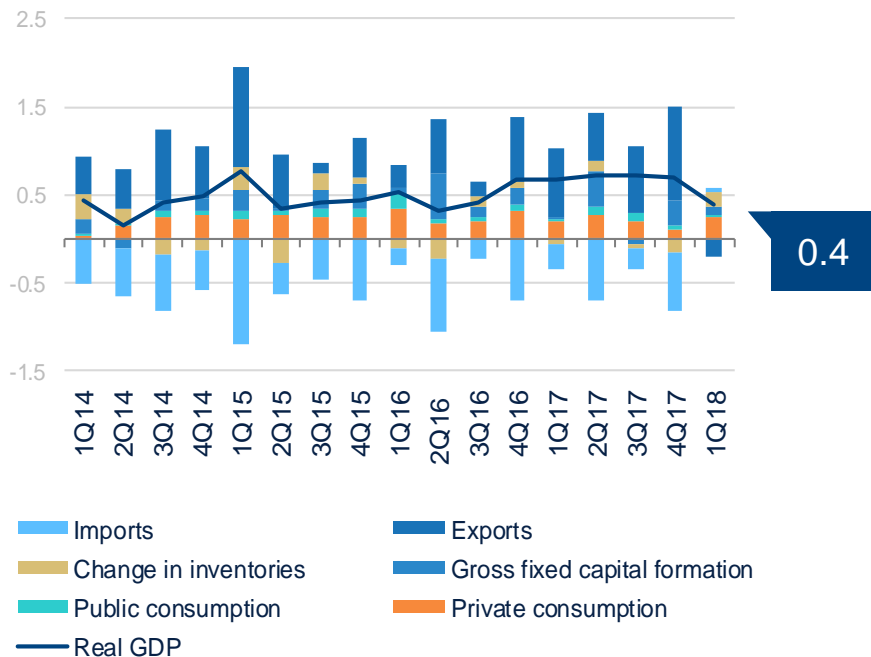
Economic developments

Hard data improved in May but failed to recover from disappointing figures in 1Q18.
Confidence seem to level off up to July despite increasing uncertainty.

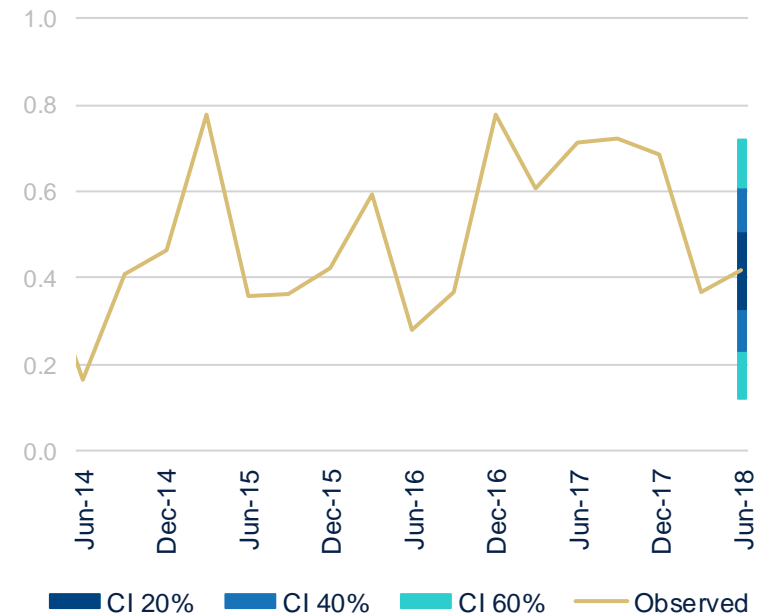
Growth slowed down in early year but is expected to stabilize in 2Q18

■ After slowing down to 0.4% QoQ in 1Q18, our **MICA-BBVA model** points to a **similar pace of GDP growth in 2Q18**, supported by the strength of domestic demand

GDP, contribution by components (%QoQ, pp)



GDP and MICA forecasts (%QoQ)

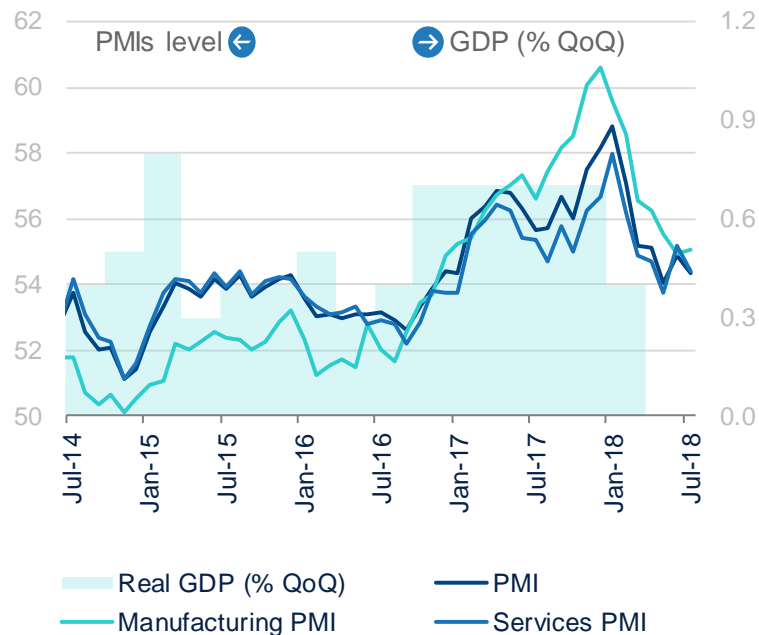


Confidence indicators seem to level off up to July and remain resilient despite increasing uncertainty

■ Confidence has stabilized after declining in early 2Q, while worries about protectionism are still latent in surveys. Lower confidence is still consistent with a robust but more moderate growth in coming quarters

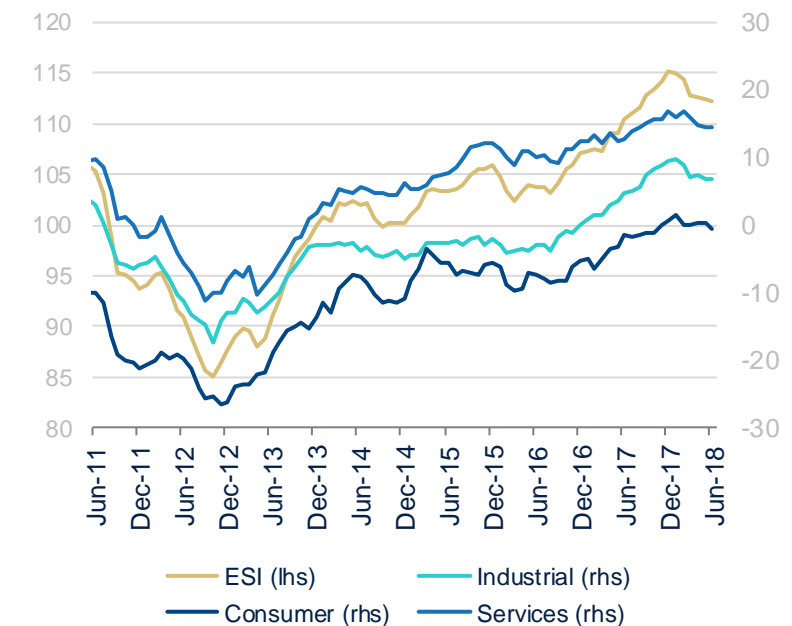
PMI and GDP

(level, %QoQ)



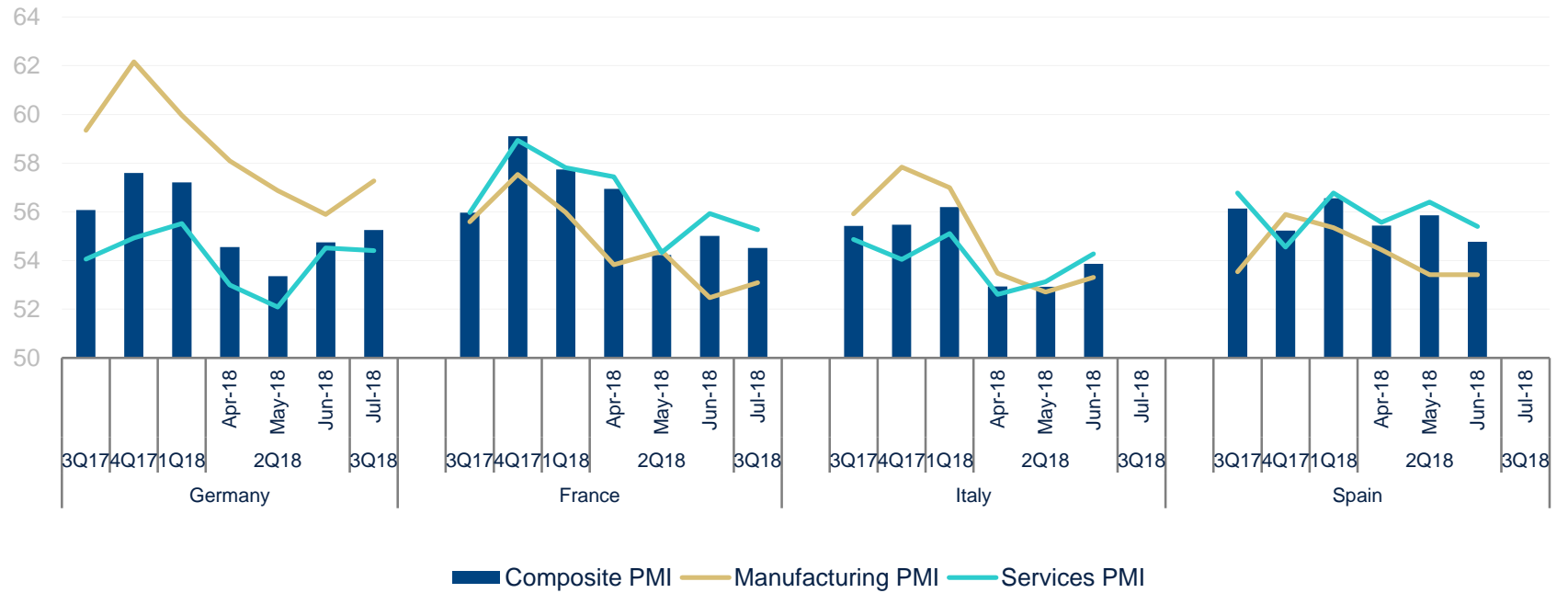
EC confidence survey

(level)



Composite PMIs bounced back in larger countries driven by services, except in Spain

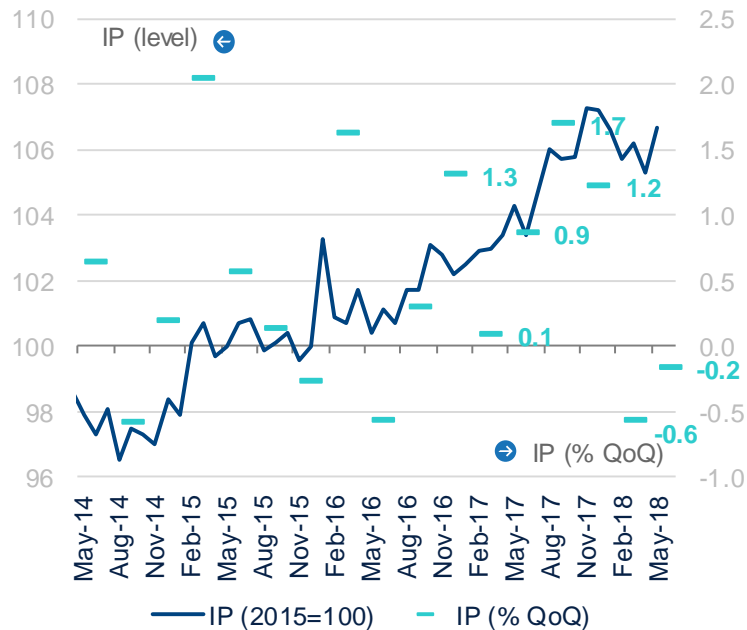
PMI survey (level)



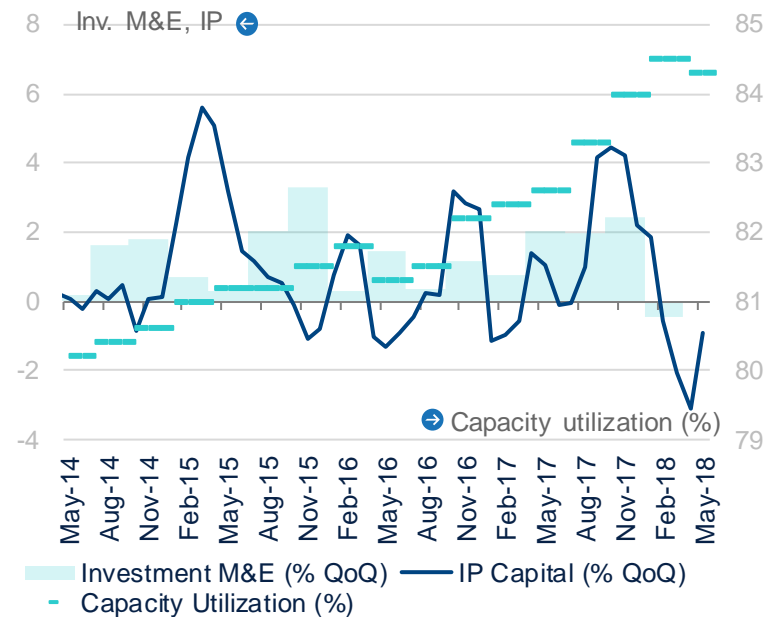
Industrial output bounced back in May, partially reverting the falls of previous months

■ IP rebounded in May (+1.3% MoM) showing increases in all types of goods, especially durables (+2.1% MoM) and capital (+0.7% MoM)

Industrial production (level, %QoQ)



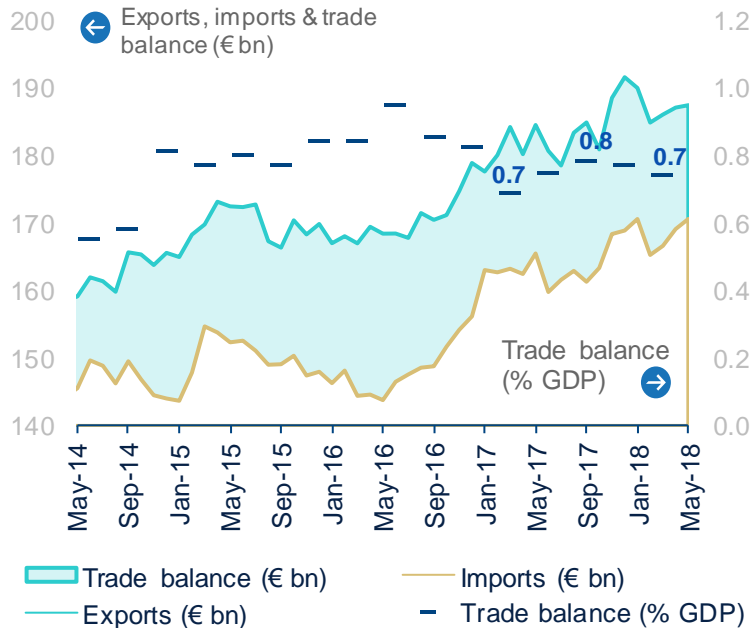
IP capital equipment, investment in M&E and capacity utilization (%QoQ, %)



Higher growth of imports relative to moderated exports have slightly narrowed the trade balance

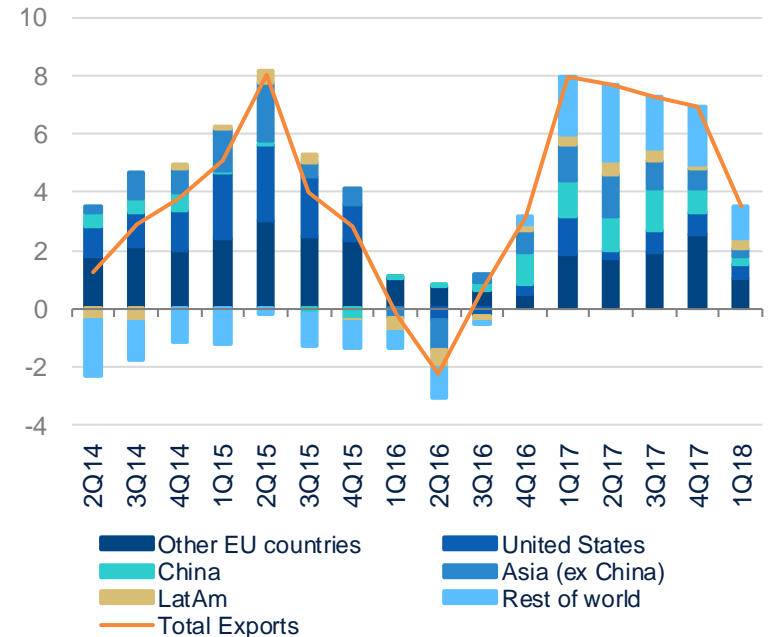
Trade balance

(€ bn, % GDP)



Exports by destination

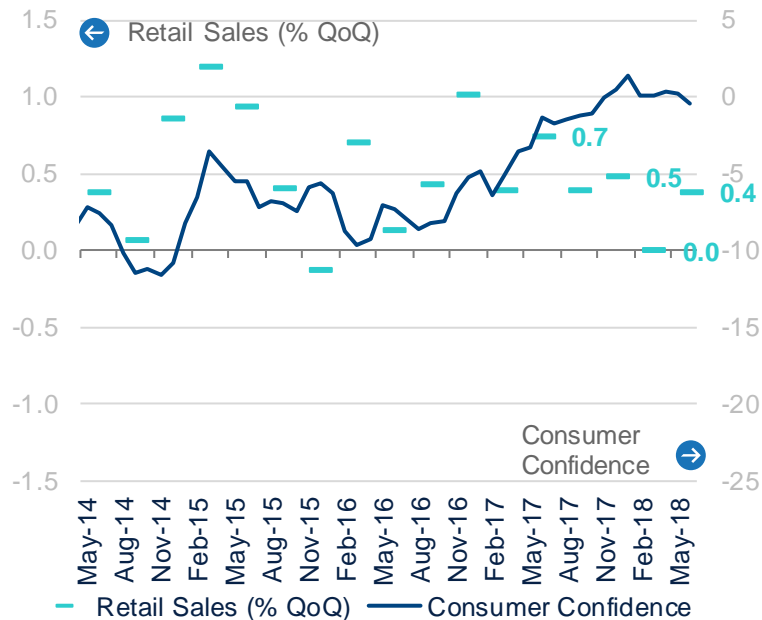
(%YoY, pp)



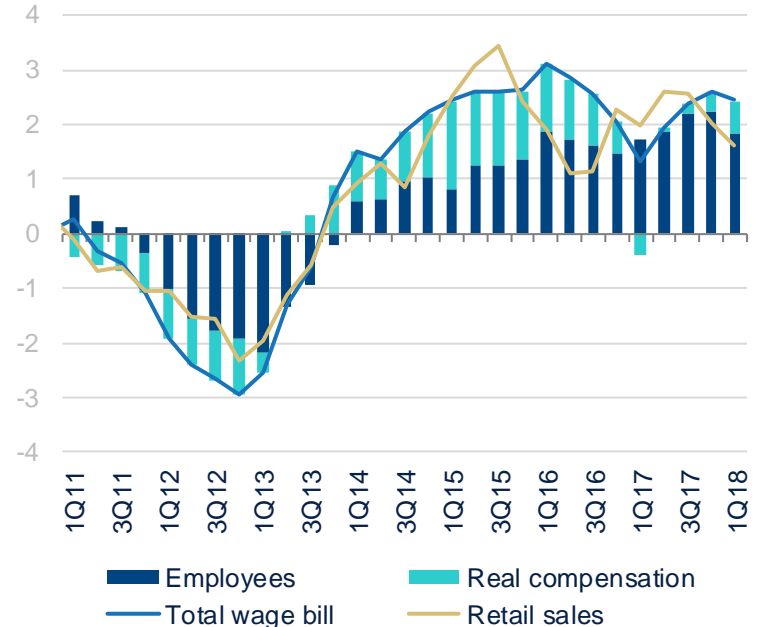
Retail sales have recovered after disappointing in 1Q18 as consumer mood remained supportive for households

- Retail sales increased slightly in May and should continue to rise in coming months driven by robust employment growth and confidence levels

Retail sales and consumer confidence (%QoQ, level)



Retail sales and total wage bill (%YoY, pp)

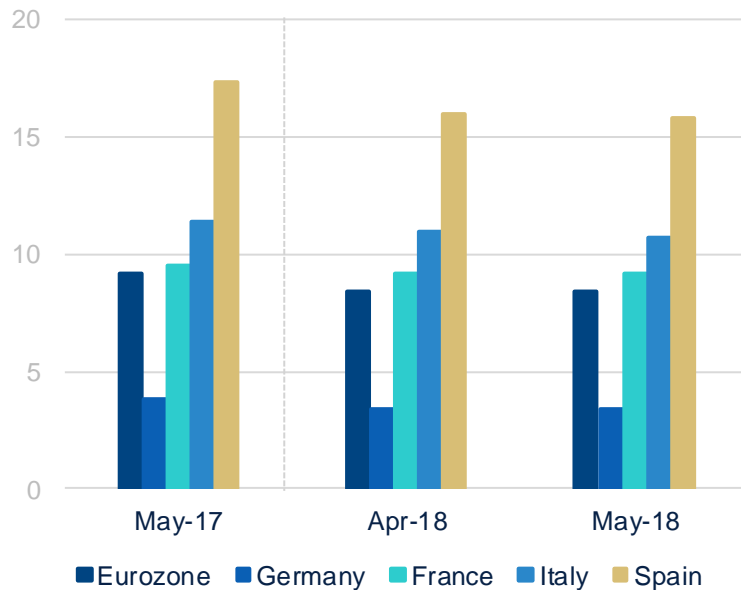


The jobless rate remained steady in May but with further declines in Italy and Spain

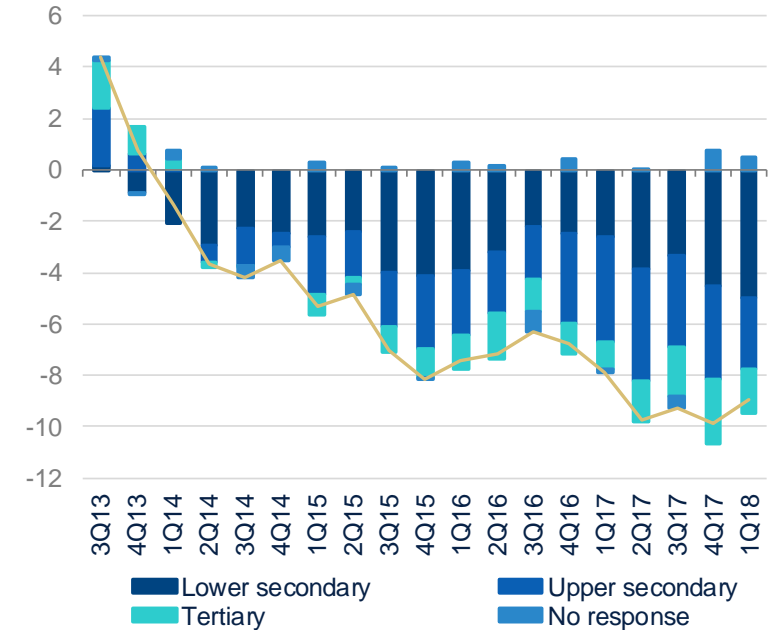
■ The unemployment rate remained flat at 8.4% in May, while the previous month it was revised down by 0.1pp

■ The annual fall in unemployment is concentrated in the less skilled but with increasing contributions from the high-skilled

Unemployment rate by country
(%)



Change in unemployment by educational attainment
(% YoY; pp)

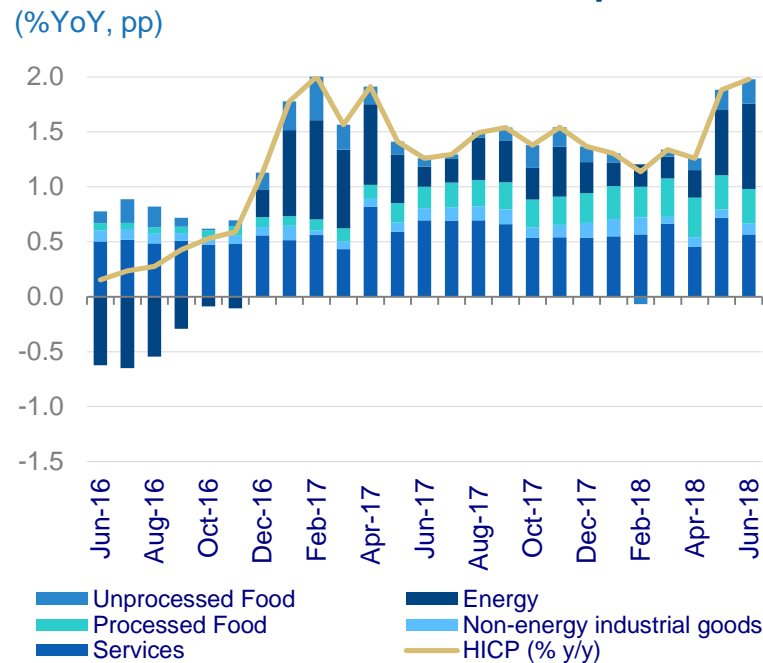


Headline inflation already reached 2% although the core measure remains broadly stable at low levels

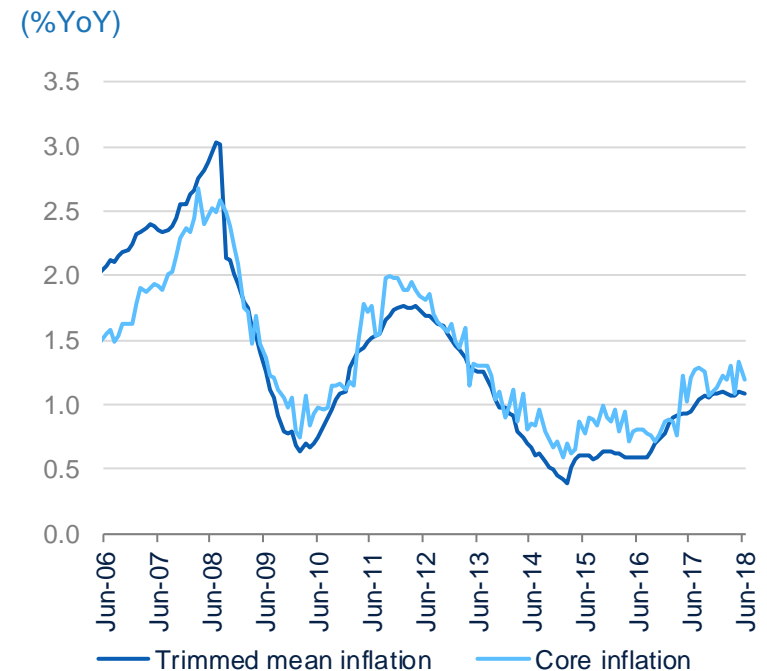
■ HICP headline increased to 2.0% YoY (+0.1pp) in June, driven mostly by energy and non-processed food

■ Core inflation eased a bit to 1.2% YoY (-0.1pp), still showing a gradual recovery

Inflation and contribution of components (%YoY, pp)

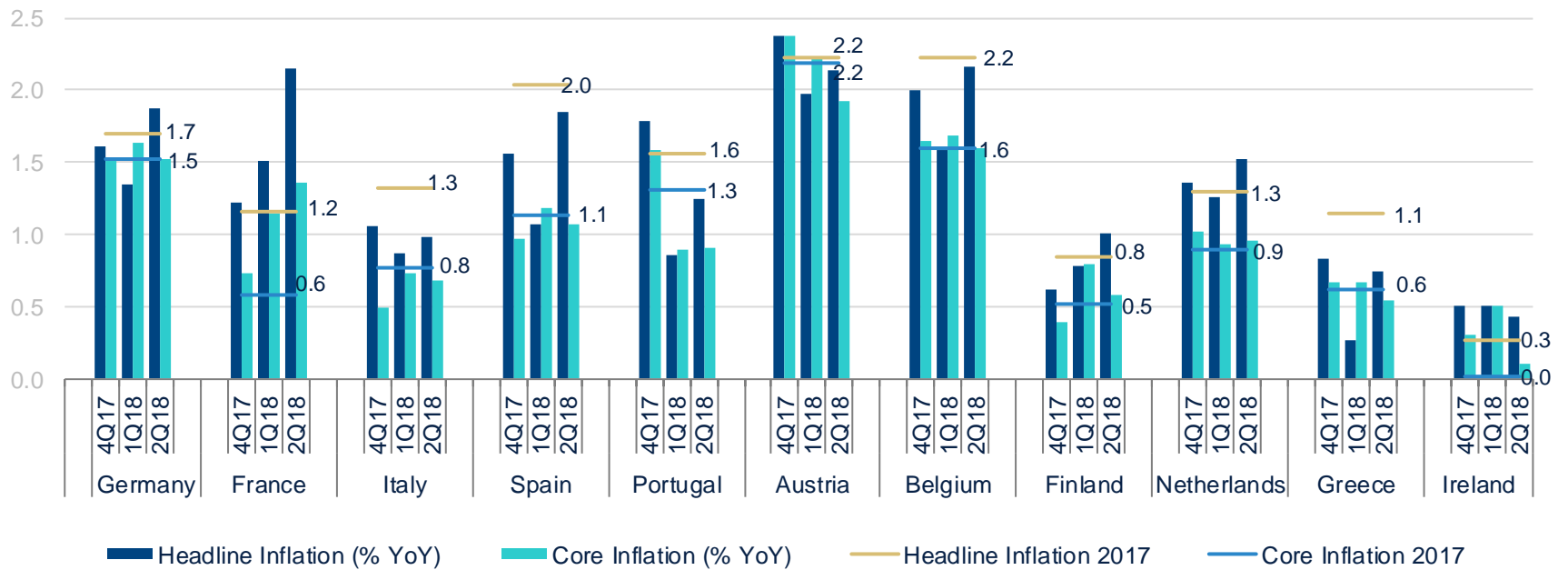


Core and trimmed-mean inflation (%YoY)



There was a widening gap between headline and core inflation in all countries during 2Q18

Headline and core inflation (%YoY)





02

Updated forecasts

Eurozone gears towards more moderate, but solid growth.
Core inflation is expected to increase gradually over the forecast horizon.

Eurozone growth drivers: higher uncertainty and commodity prices weigh on activity despite resilient domestic and global demand

01 

Resilient domestic factors

Still improving labour markets, stable profits and favourable lending conditions

04 

Core inflation at low levels

Nascent inflationary pressures should support a gradual upward trend in core inflation in coming months

02 

Steady global expansion

Eurozone exports could benefit from a weaker euro and robust global demand, but a more moderate growth than in 2017

05 

Supportive economic policies

Slightly expansionary fiscal policy, added to very gradual ECB's exit (rate hikes delayed to summer 2019)

03 

Higher oil price & trade threat

Lower disposable income and profits. Limited effect of approved protectionist measures, but they could dampen confidence and investment

06 

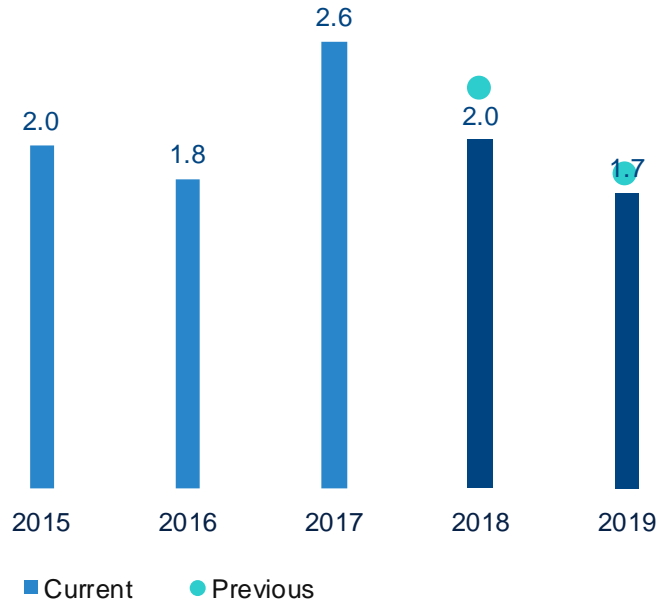
Risks intensify further

A full blown trade war risk increased; added to higher domestic political uncertainty

A rapid shift to more moderate growth

- Downward revision in 2018 and 2019 GDP growth (-0.3pp to 2.0% and -0.1pp to 1.7%) to account for lower than expected 1Q18 growth figures
- Although slowing, the investment recovery remains on track, adding to resilient consumption
- A weaker euro and still strong global demand will continue to support exports
- Both higher oil and import prices to push up headline inflation (+0.2pp in 2018-19). Core measure increasing only gradually as wage inflation recovers

Eurozone GDP growth and forecast (%)



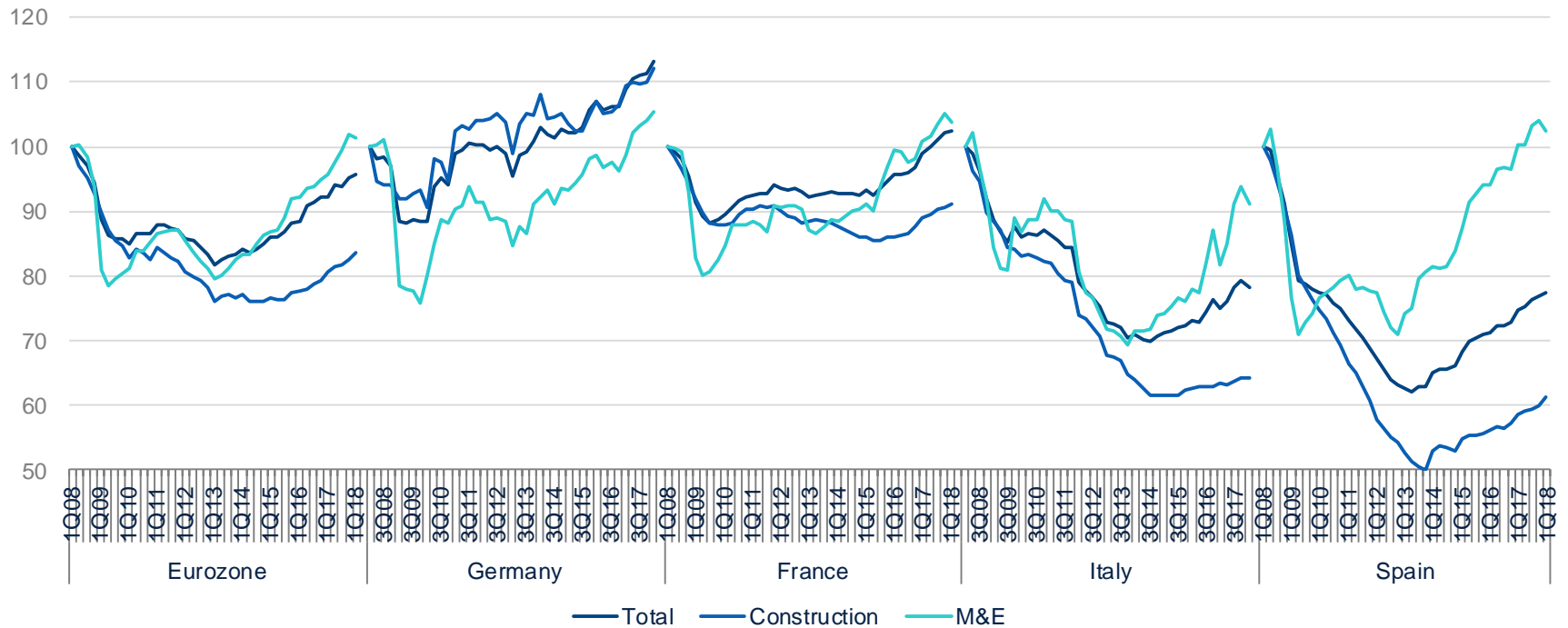
Main macroeconomic indicators (% YoY, %GDP)

| | 2016 | 2017 | 2018 (f) | 2019 (f) |
|-----------------------------------|-------------|------------|------------|------------|
| Real GDP | 1.8 | 2.6 | 2.0 | 1.7 |
| Private consumption | 1.9 | 1.7 | 1.5 | 1.5 |
| Public consumption | 1.8 | 1.2 | 1.2 | 1.2 |
| Investment | 4.5 | 3.5 | 3.0 | 2.9 |
| Domestic demand (cont. pp) | 2.2 | 1.9 | 1.7 | 1.7 |
| Exports | 3.3 | 5.5 | 4.1 | 4.2 |
| Imports | 4.6 | 4.5 | 3.7 | 4.4 |
| Net exports (cont. pp) | -0.4 | 0.7 | 0.3 | 0.1 |
| Current account (% GDP) | 3.6 | 3.5 | 3.4 | 3.2 |
| Budget balance (% GDP) | -1.5 | -0.9 | -0.7 | -0.7 |
| HICP (avg. %YoY) | 0.2 | 1.5 | 1.7 | 1.8 |

Investment recovery is broad-based across countries in both construction and M&E

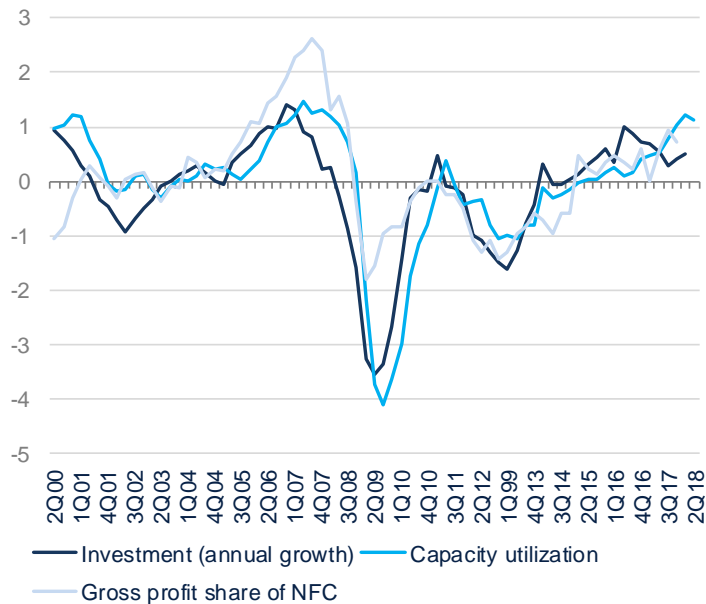
Investment by country

(1Q18=100)

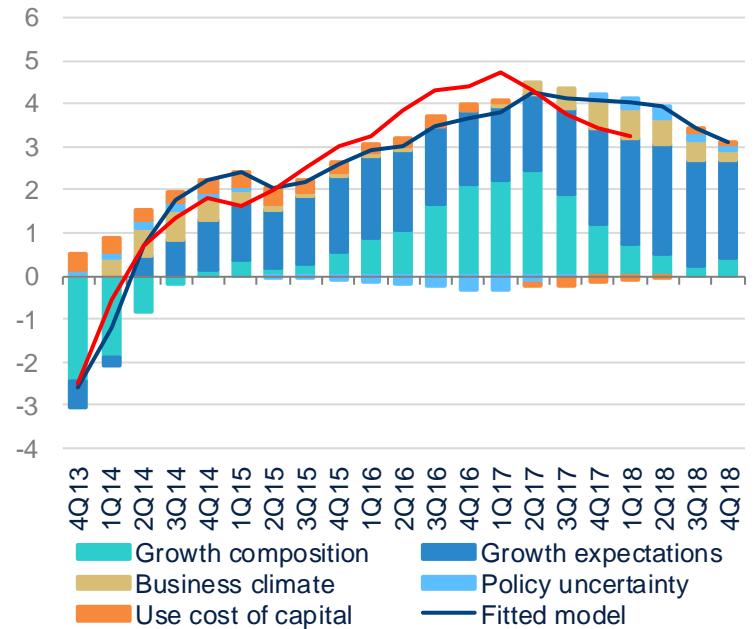


Uncertainty could weigh on investment but profits and lower idle capacity should underpin a solid growth

Investment, capacity utilization and profit share
(normalized)



Investment and drivers contributions
(% annual moving average, pp)

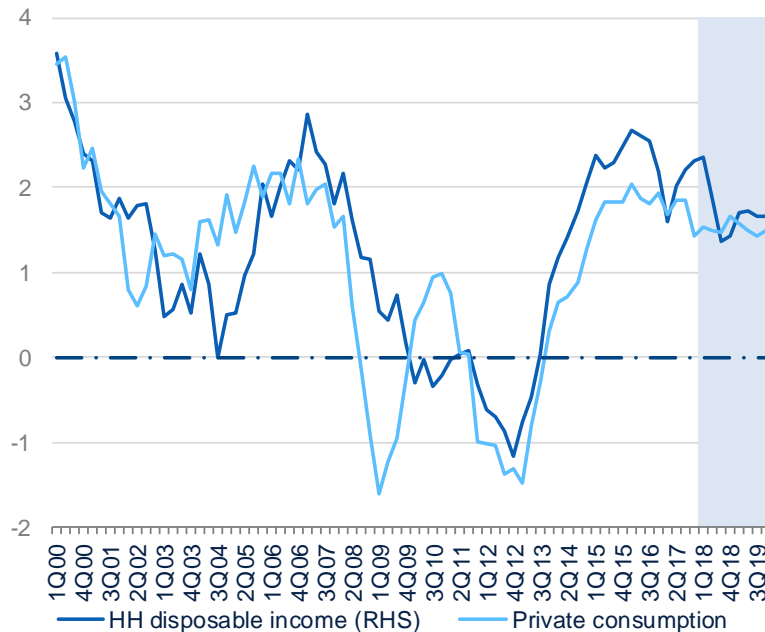


More moderate private consumption driven by slower real wage growth (due to higher inflation)

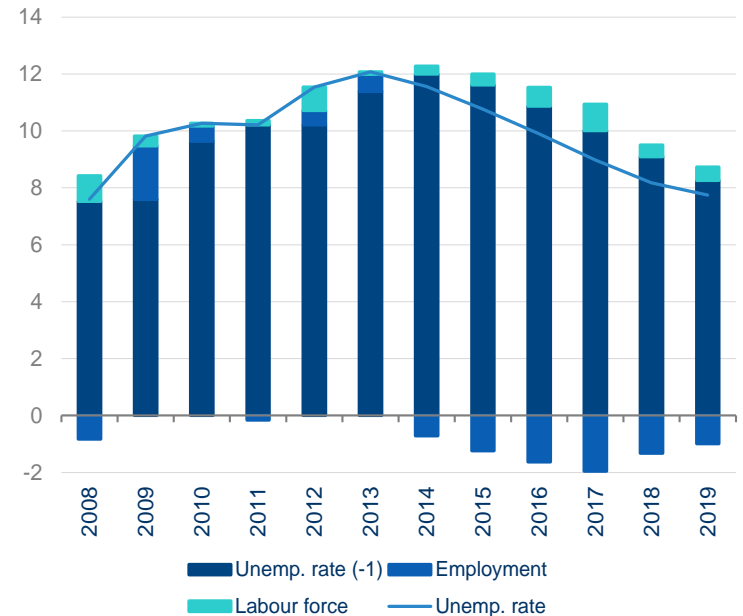
■ Disposable income has shown strong growth driven by **robust job creation**, but will be **offset by higher inflation**

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

Private consumption and real labour income (% YoY)

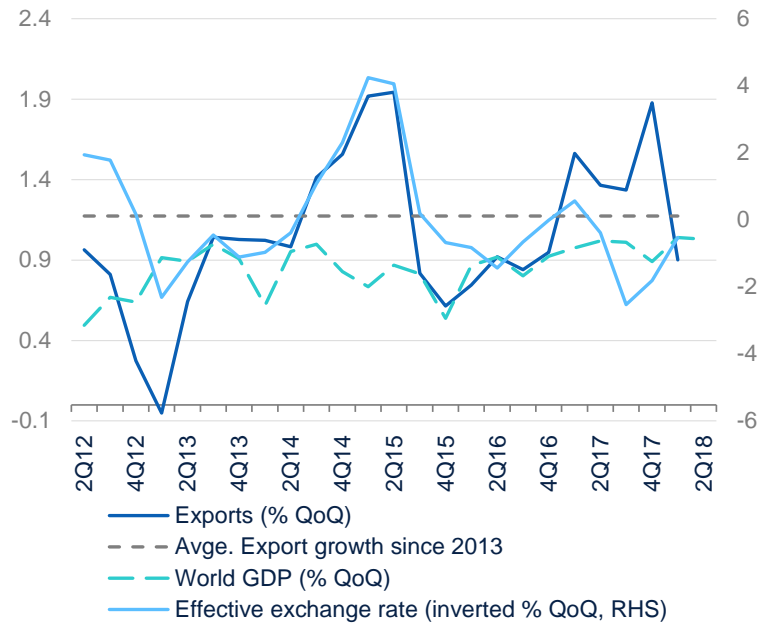


Unemployment rate and contribution (% pp)

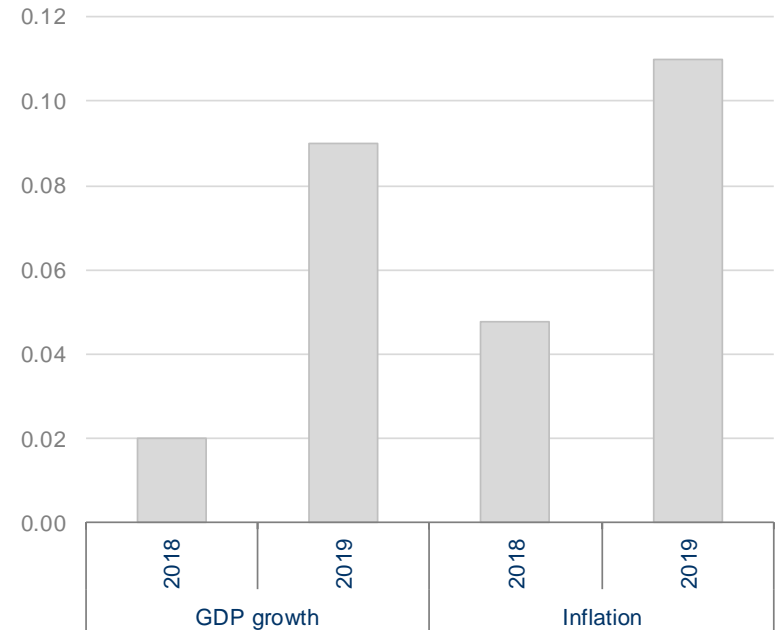


Recent euro depreciation will help boosting export competitiveness but also higher inflation

Exports, EURUSD and World GDP (% QoQ)



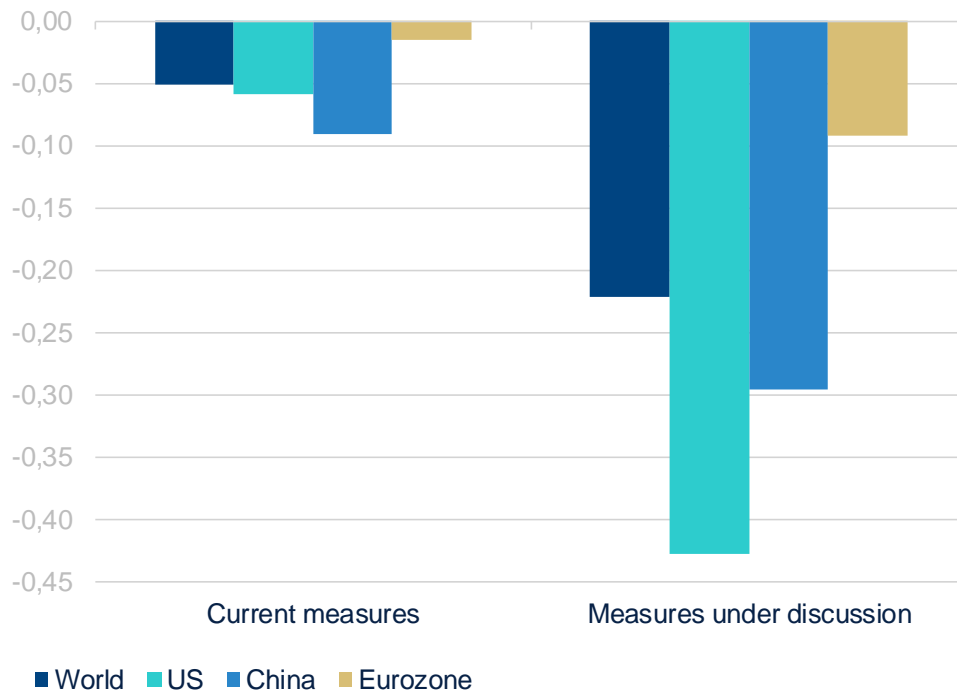
Effect of euro depreciation on GDP growth and inflation (pp)



Limited effect of approved new tariffs, but it could be significant if those under discussion are implemented

Effect on GDP growth of higher US tariffs and retaliation from affected countries

(2018-19, pp)

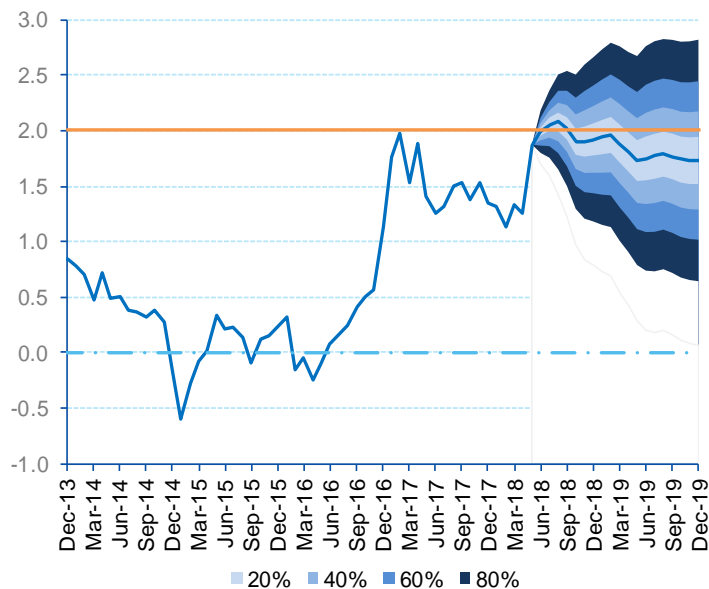


- The tariffs increase approved by the US would have a reduced direct impact on GDP. But indirect effects, via economic confidence and financial channel, could emerge in 2S18.
- If protectionist escalated, the negative effect on growth would also be significant in the US
- The effect, lower in Europe, would differ by country, and would affect mainly Germany and the Eastern countries
- Global GDP growth could be reduced but around 0,2pp due to the trade channel. If confidence and financial conditions worsened, protectionist measures could take a further 0.3pp away from global growth (to around -0.5pp)

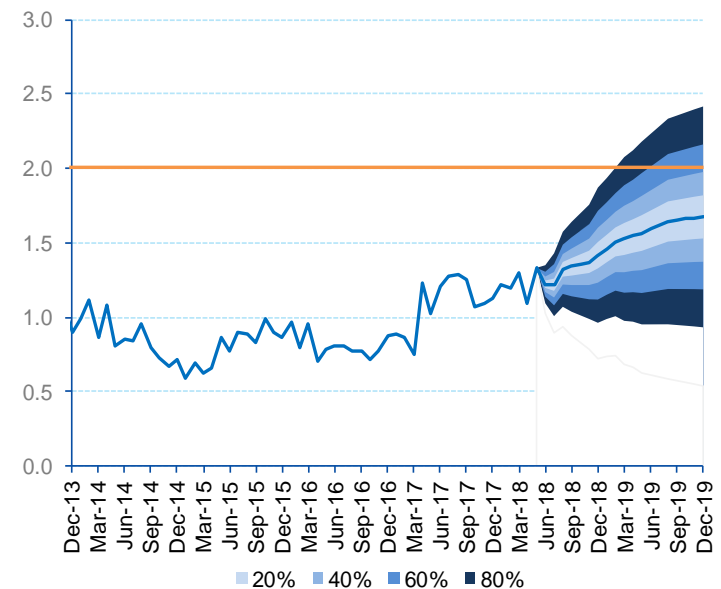
Easing energy inflation will be offset by higher core prices over the next year

- Higher headline inflation due to both oil price increase and euro depreciation. Reaching an average of 1.7% and 1.8% in 2018-19 (revised up by +0.2pp in both years)
- No major changes in core inflation projections, with only gradual increases as wage inflation recovers (average of 1.1% and 1.6% in 2018-19, the latter revised up by +0.1pp)

HICP headline inflation and forecast (% YoY)



HICP core inflation and forecast (% YoY)



The ECB delayed rate hikes until next summer following a strong guidance to avoid a market turmoil

QE



NO CHANGES

The QE will end in 2018

- Monthly purchases of EUR30bn up to September
- Then monthly buys of EUR15bn until December

Interest rates



Strong and explicit guidance on rates. Delay in rate rises until September 2019

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

The challenge for the ECB to manage rates expectations has been met

Key issues in QE exit:



Long interest rates and risk premium



Exchange rate (Euro)



Expectations on interest rate hikes



Germany: A more moderate growth driven by slower exports but still robust investment

Main macroeconomic indicators

(% YoY, %GDP)

| | 2016 | 2017 | 2018 (f) | 2019 (f) |
|-----------------------------------|-------------|------------|------------|------------|
| Real GDP | 1.9 | 2.5 | 1.9 | 1.7 |
| Private consumption | 1.9 | 2.0 | 1.4 | 1.5 |
| Public consumption | 3.7 | 1.5 | 1.3 | 1.7 |
| Investment | 2.9 | 4.0 | 3.4 | 3.0 |
| Domestic demand (cont. pp) | 2.2 | 2.3 | 1.8 | 1.7 |
| Exports | 2.4 | 5.3 | 5.0 | 4.1 |
| Imports | 3.8 | 5.6 | 5.4 | 4.8 |
| Net exports (cont. pp) | -0.4 | 0.2 | 0.1 | 0.0 |
| Current account (% GDP) | 8.5 | 8.1 | 7.9 | 7.3 |
| Budget balance (% GDP) | 1.0 | 1.3 | 1.2 | 1.3 |
| HICP (avg. %YoY) | 0.4 | 1.7 | 1.9 | 1.9 |

- GDP growth forecasts were revised down in 2018 (-0.5pp) and 2019 (-0.1pp) mostly due to lower than expected data on exports and consumption in 1Q18
- Private consumption will moderate due to a tighter labour market and higher inflation
- Euro depreciation and still positive global outlook will continue to support trade figures and investment although increasing protectionism pose downside risks (automotive sector)
- Public expenditure expected to support domestic demand but in a context of an almost neutral fiscal policy stance
- Local risks eased but remained latent, mostly coming from a weakened government coalition that could weigh on confidence

France: Growth revised down in 2018 given both higher inflation and a stalled domestic demand

Main macroeconomic indicators

(% YoY, %GDP)

| | 2016 | 2017 | 2018 (f) | 2019 (f) |
|-----------------------------------|-------------|------------|------------|------------|
| Real GDP | 1.1 | 2.3 | 1.8 | 1.6 |
| Private consumption | 1.9 | 1.2 | 1.1 | 1.3 |
| Public consumption | 1.4 | 1.4 | 1.4 | 1.4 |
| Investment | 2.7 | 4.7 | 2.9 | 2.6 |
| Domestic demand (cont. pp) | 1.6 | 2.2 | 1.4 | 1.6 |
| Exports | 1.5 | 4.7 | 3.5 | 3.4 |
| Imports | 3.1 | 4.1 | 2.3 | 3.2 |
| Net exports (cont. pp) | -0.5 | 0.1 | 0.3 | 0.0 |
| Current account (% GDP) | -0.8 | -0.6 | -0.5 | -0.6 |
| Budget balance (% GDP) | -3.4 | -2.6 | -2.5 | -2.3 |
| HICP (avg. %YoY) | 0.3 | 1.2 | 1.8 | 1.8 |

- We revised down GDP growth in 2018 to 1.8% (-0.2pp) after higher growth in 2017 supported by exports (revised up by +0.3pp)
- Incoming data showed a **slowdown in domestic demand**, mostly investment
- Private **consumption growth** to be hit by **higher inflation**
- **Lower import growth** will increase the contribution net external demand this year
- Fiscal consolidation and reforms could be delayed by the risk of **heightened social discontent**

Italy: Still lagging behind while facing increasing political risks

Main macroeconomic indicators

(% YoY, %GDP)

| | 2016 | 2017 | 2018 (f) | 2019 (f) |
|-----------------------------------|-------------|------------|------------|------------|
| Real GDP | 1.0 | 1.6 | 1.1 | 1.2 |
| Private consumption | 1.4 | 1.4 | 1.0 | 1.0 |
| Public consumption | 0.6 | 0.1 | 0.2 | 0.4 |
| Investment | 3.3 | 3.9 | 3.0 | 2.1 |
| Domestic demand (cont. pp) | 1.3 | 1.4 | 1.1 | 1.0 |
| Exports | 2.6 | 6.0 | 3.2 | 3.4 |
| Imports | 3.8 | 5.7 | 3.4 | 3.1 |
| Net exports (cont. pp) | -0.3 | 0.2 | 0.0 | 0.2 |
| Current account (% GDP) | 2.6 | 2.8 | 2.9 | 2.3 |
| Budget balance (% GDP) | -2.5 | -2.3 | -1.9 | -1.9 |
| HICP (avg. %YoY) | -0.1 | 1.3 | 1.3 | 1.7 |

- We revised down GDP growth forecasts in 2018-19 (with -0.4pp and -0.1pp, respectively)
- Although investment figures will continue to underpin growth, higher uncertainty stalled the pace of recovery
- Private consumption should moderate, mostly dragged down by higher inflation
- The still positive global trade outlook will support exports, but imports will offset their contribution to growth
- Policy uncertainty and risks of populism remain latent and increasing

Spain: Unchanged GDP growth forecasts with supportive policies counteracting headwinds

Main macroeconomic indicators

(% YoY, %GDP)

| | 2016 | 2017 | 2018 (f) | 2019 (f) |
|-----------------------------------|------------|------------|------------|-------------|
| Real GDP | 3.3 | 3.1 | 2.9 | 2.5 |
| Private consumption | 2.9 | 2.4 | 2.6 | 2.1 |
| Public consumption | 0.8 | 1.6 | 2.0 | 2.0 |
| Investment | 3.3 | 5.0 | 4.3 | 5.6 |
| Domestic demand (cont. pp) | 2.5 | 2.8 | 2.8 | 2.7 |
| Exports | 4.8 | 5.0 | 3.5 | 6.0 |
| Imports | 2.7 | 4.7 | 3.6 | 7.1 |
| Net exports (cont. pp) | 0.7 | 0.3 | 0.1 | -0.2 |
| Current account (% GDP) | 1.9 | 1.7 | 1.3 | 1.5 |
| Budget balance (% GDP) | -4.3 | -3.1 | -2.8 | -2.1 |
| HICP (avg. %YoY) | -0.2 | 2.0 | 1.8 | 1.7 |

- GDP growth forecasts are maintained at 2.9% and 2.5% in 2018 and 2019
- Some changes in demand composition with both exports and investment (M&E) negatively affected by headwinds (e.g. supply constraints, higher oil price and the Eurozone slowdown)
- Consumption will keep growing while investment in construction accelerates
- Supportive monetary and fiscal policy will counteracts headwinds
- Political uncertainty, and the costs of a pro-cyclical fiscal stance are the main local risk

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July 2018



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