BBVA Research

Eurozone Economic Watch

October 2018

Creando Oportunidades

Eurozone: Unchanged forecast of steady moderate growth, but downward risks are mounting

- The Eurozone GDP growth has stabilized at lower levels due to weaker foreign demand and sluggish private consumption, but should remain steady due to the resilience of domestic factors. Our BBVA-MICA projects at quarterly GDP growth of 0.4% QoQ in 3Q18.
- Hard data has improved in August, partly reverting previous falls. The industrial recovery proceeds at a lower pace, while private consumption and investment should continue to support growth. Exports widened further in August, but the rising trend in imports will presumably drag economic growth in 3Q18.
- Worsening confidence resumes in October, after some resilience in previous months, raising concerns about the negative effect of increasing uncertainty and a further moderation by year end. But data is still very limited.
- Our GDP growth forecasts remain unchanged at 2.0% for 2018 and 1.7% for 2019 as strong domestic factors are still expected to offset uncertainty and a more tempered global demand
  - Slight shift in the growth composition: more solid private consumption and investment should compensate a smaller contribution of net exports despite moderate export growth (supported by a weaker euro and robust global demand)
  - Fiscal and monetary policy will continue to support domestic demand, in addition improving labour market.
- Rising oil prices could keep inflation around 2% for the remainder of the year, but a moderating base effect from energy prices will kick in next year. Core inflation remains subdued, and should maintain a gradual increase on the back of strong domestic demand and a pickup of wages.
- Downward risks to this scenario have intensified: Higher political uncertainty in Europe (Brexit, Italy, a stalemate in the Eurozone reform) is added to a potential full-blown trade war and a faster Fed's exit.

01

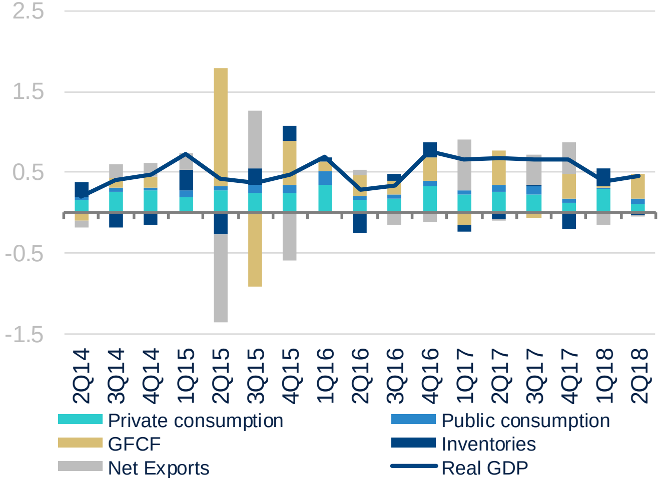
Economic developments

Hard data improved in August, partly reverting previous falls: resilient domestic demand, but net exports could continue to weigh on growth.

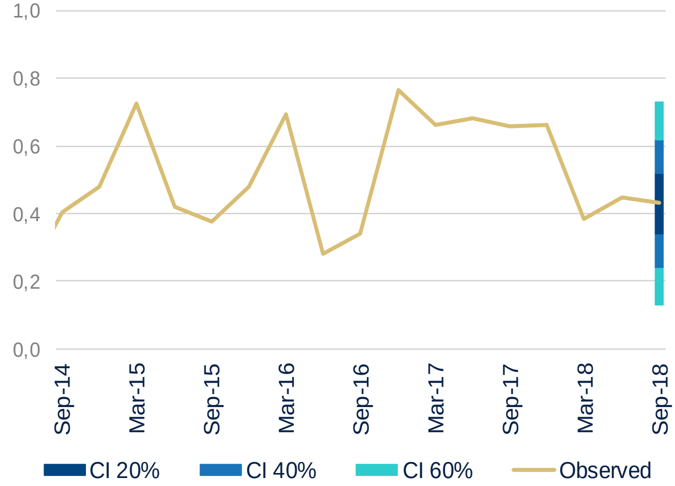
Worsening confidence resumes in October, after some resilience in previous months, raising concerns about the negative effect of increasing uncertainty.

The Eurozone economy has shifted down a gear but is still growing steadily

GDP, contribution by components
(%, QoQ)



GDP and MICA forecasts
(%, QoQ)



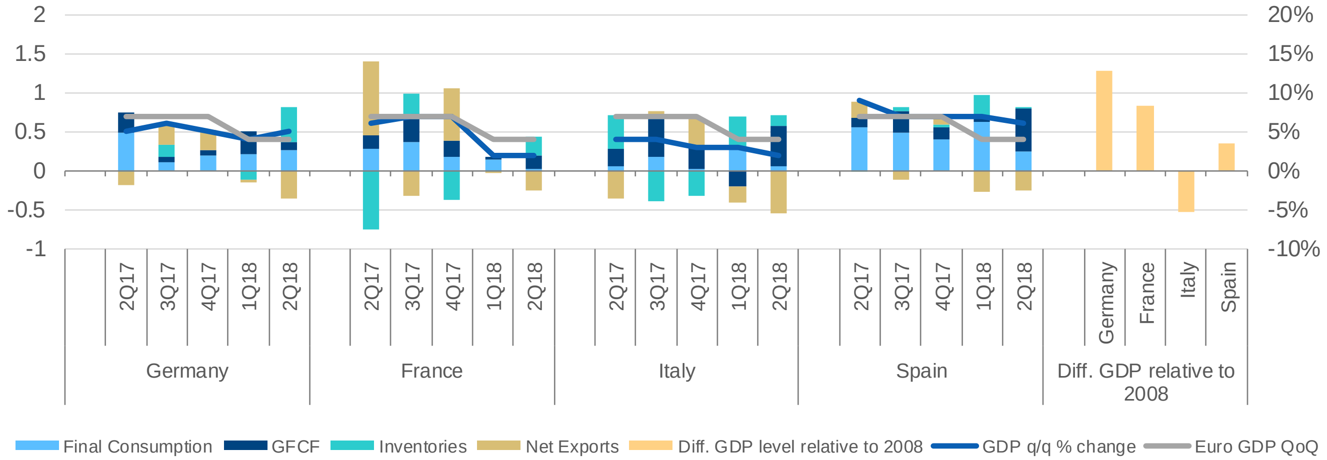
3Q18 GDP growth is expected to remain stable at 0.4% QoQ. Domestic demand should remain resilient, but net exports could continue to weigh on growth.

Source: Eurostat and BBVA Research

More moderate growth across countries, with differences stemming from the strength of their domestic demand

GDP and expenditure contribution by country

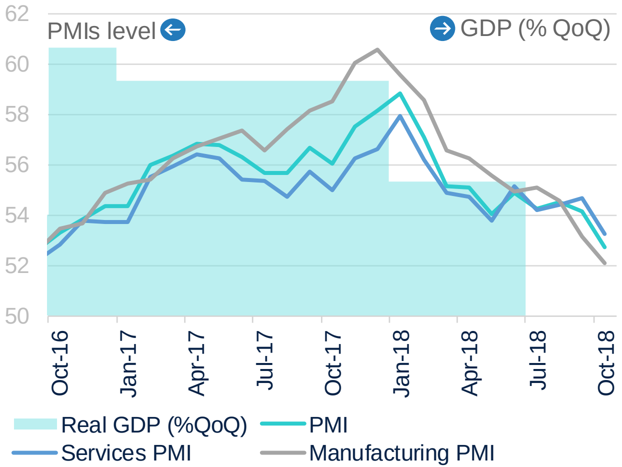
(%QoQ, pp)



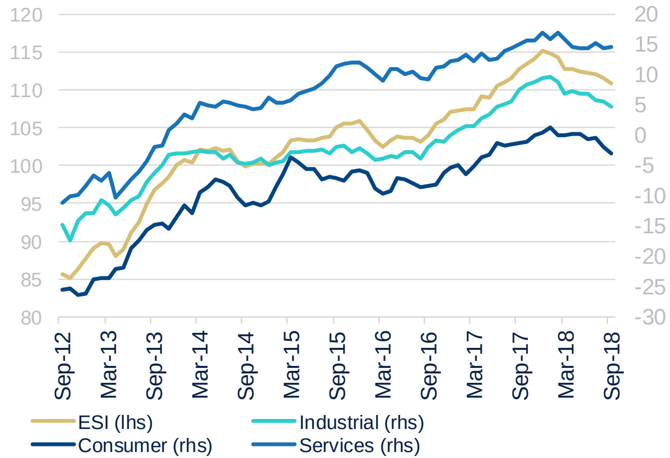
Source: Eurostat and BBVA Research

PMIs extend their downward trend in October and signal further weakening in both the manufacturing and the services components

PMI and GDP
(level, %QoQ)



EC confidence survey
(level)

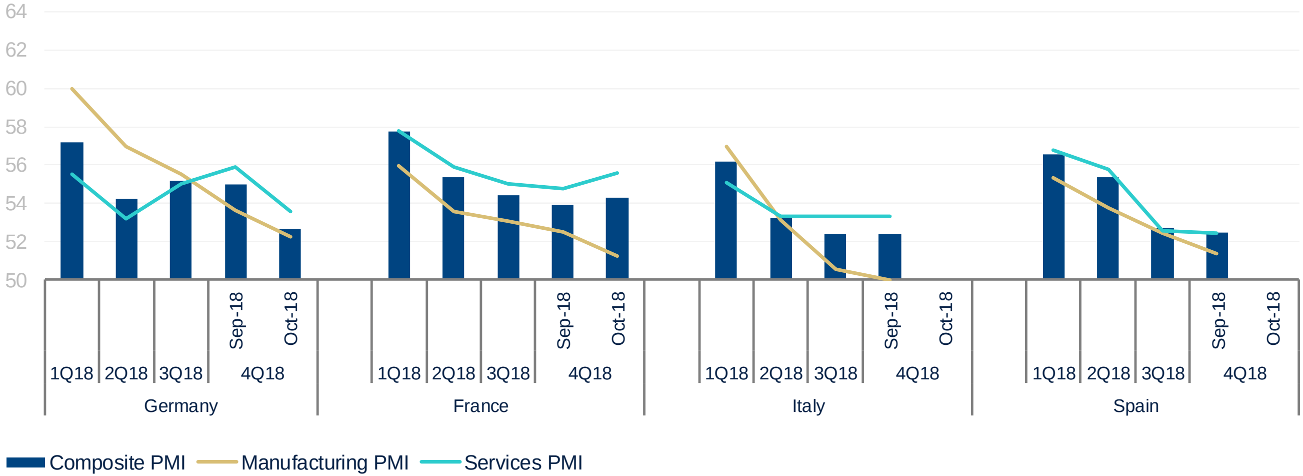


PMIs came in worse than expected in October and signal further declines in both the manufacturing and the service sector. What is perhaps more important is that leading indicators – mainly business expectations and new orders- are reaching multi-year lows as uncertainty surrounding Brexit talks and trade negotiations could take its toll on confidence and investment.

Source: Eurostat, European Commission and BBVA Research

Manufacturing PMIs extend their downward trend in October and the service sector expands in some countries and slows in others

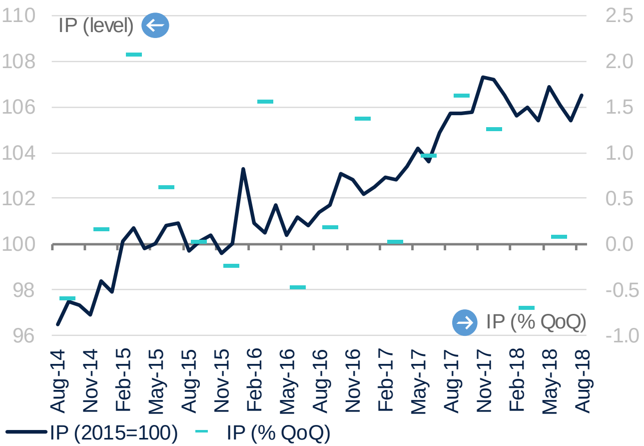
PMI Survey
(level)



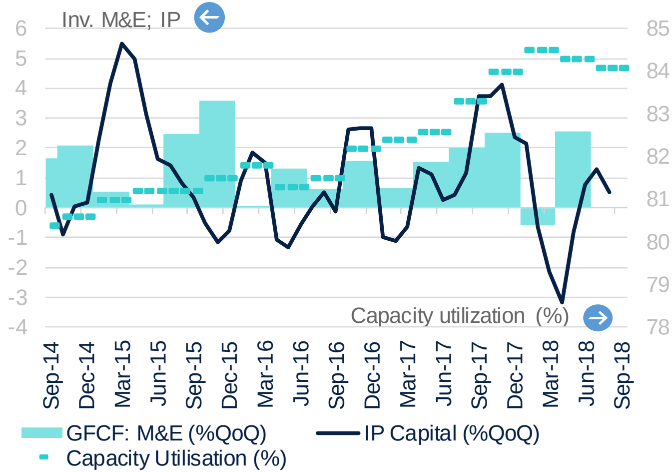
Source: Markit and BBVA Research

Industrial output rebounded in August, but has slowed significantly over the year

Industrial production
(Level, % QoQ)



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

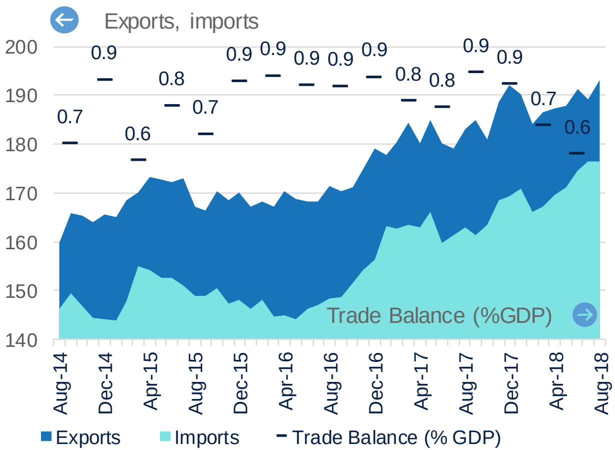


IP rebounds against expectations even though Germany production stagnated over the month on falling output in the auto sector. The industrial sector keeps recovering, but the uncertainty surrounding auto tariffs and the probability of a hard Brexit are conditioning the investment outlook.

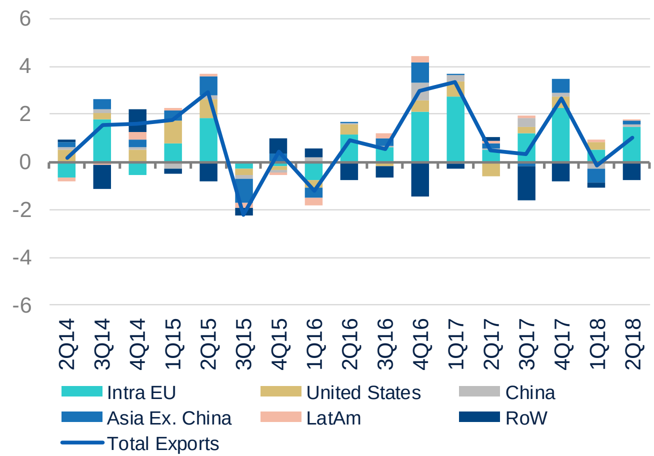
Source: Eurostat and BBVA Research

Exports widened further in August, but the rising trend in imports will presumably drag economic growth in 3Q18

Trade balance
(€bn; %GDP)



Exports by destination
(%YoY; pp)



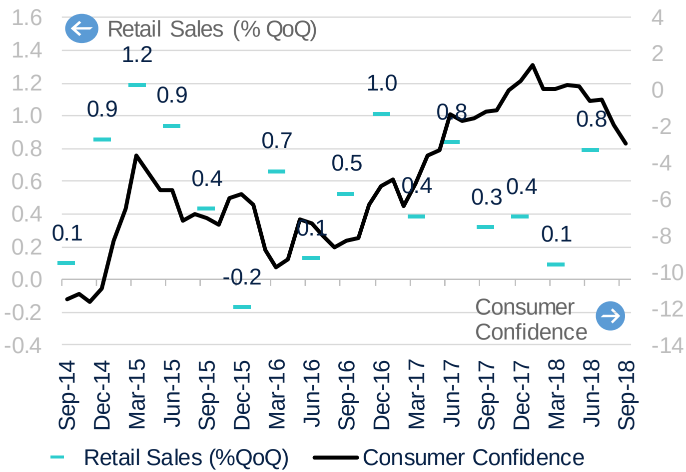
Exports accelerated significantly in August (+2.1% m/m) mainly reflecting strong demand in European counterparts. Demand for raw materials keeps accelerating despite tariffs to steel and aluminum, and the trade balance with the US widens further in the period up to August.

Source: Eurostat and BBVA Research

Retail sales have broadly remained stagnant in August, but at high levels

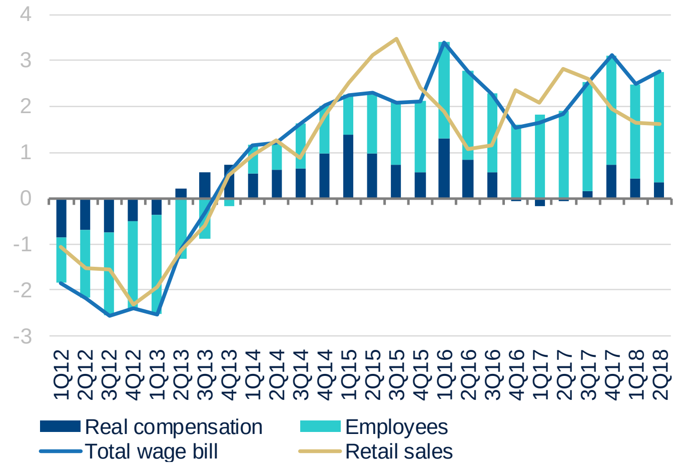
Retail sales and consumer confidence

(%QoQ, level)



Retail sales and total wage bill

(%YoY; pp)

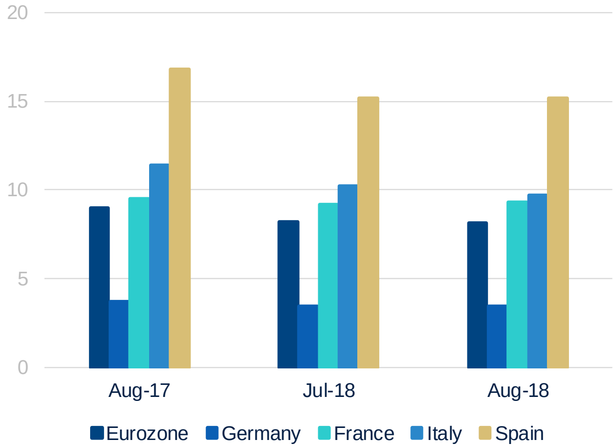


Retail sales figures (ex. autos, which have soared ahead of EU emissions test) remain broadly unchanged in August. However, consumer spending will remain strong supported by improving labour market and accommodative fiscal and monetary policies.

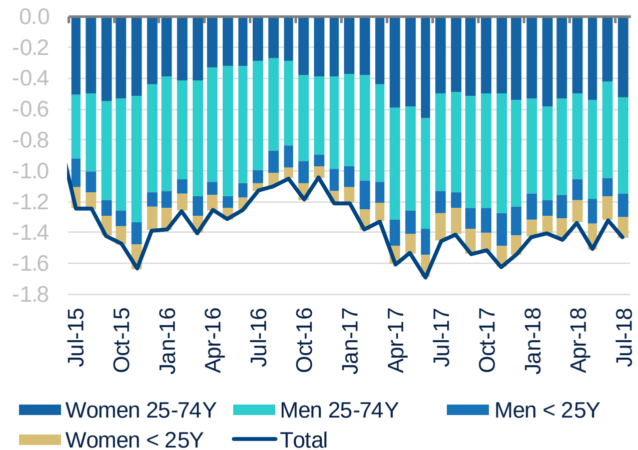
Source: Eurostat and BBVA Research

The unemployment rate keeps trending down

Unemployment rate by country
(%)



Annual unemployment change by gender and age
(millions)

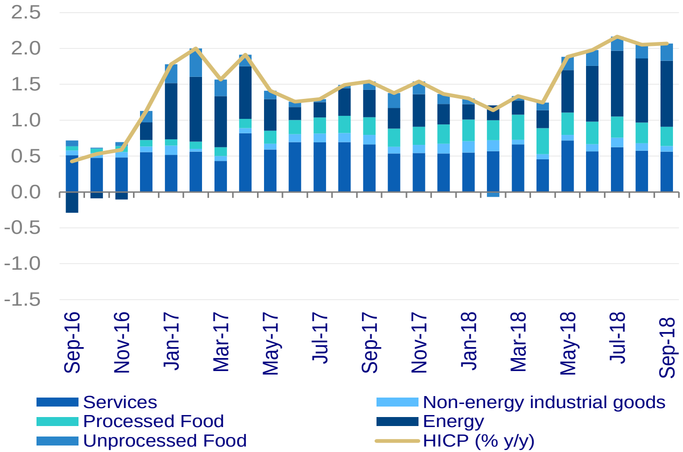


The labor market keeps tightening and labor costs increase at rates that were not seen since 2012. However, there are some barriers that could prevent further gains and challenges ahead, including the reduction of very high rates of partial employment in some of the main EZ economies, including France, Italy and Spain.

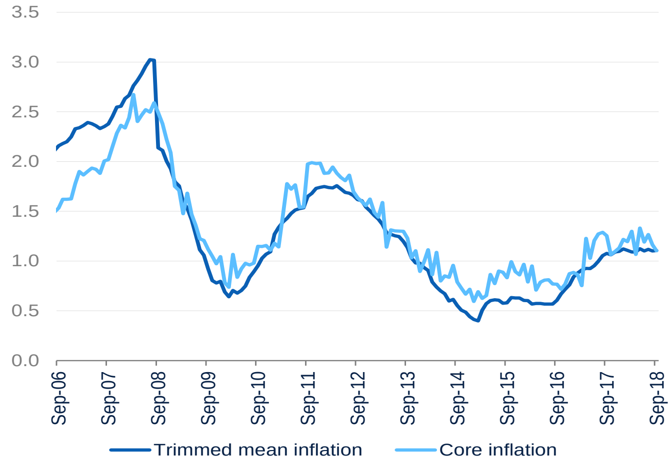
Source: Eurostat and BBVA Research

Inflation edged up slightly in September, but core inflation remained stable at low levels

Inflation contribution of components
(%YoY, pp)



Core and trimmed-mean inflation
(%YoY; pp)

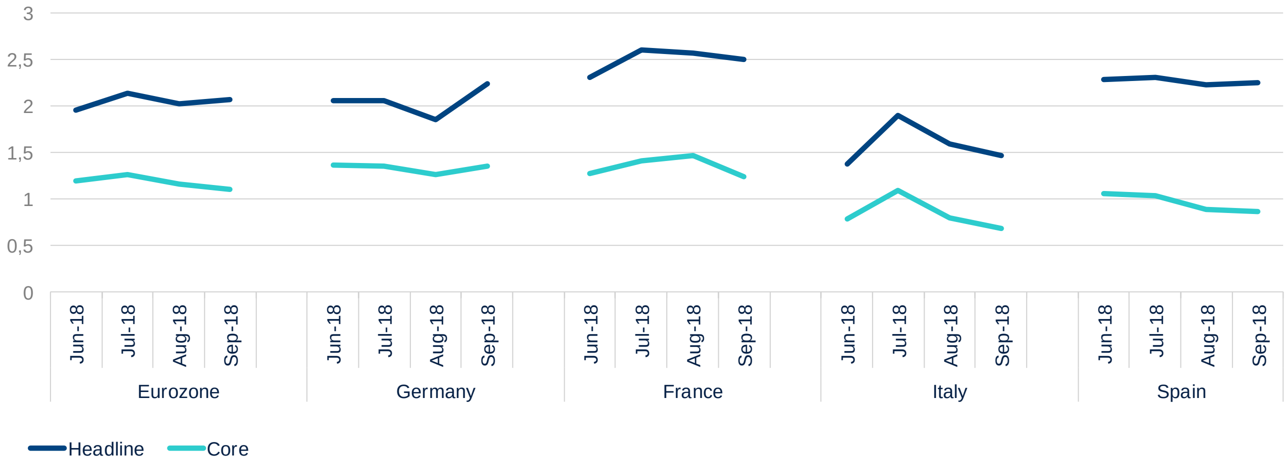


The slight increase in September (+0.1pp to 2.1% YoY) was due to higher energy prices and unprocessed food, but core inflation declined slightly (-0.1pp to 1.1% YoY) driven by lower growth in processed food prices. Inflation of both services and non-energy industrial goods remained steady.

Source: Eurostat and BBVA Research

Increasing differences in core inflation across countries

Headline and core inflation
(% YoY)



Source: Eurostat and BBVA Research

02

Updated forecasts

Less supportive external demand could be offset by a solid outlook for investment and private consumption. Core inflation is expected to increase gradually over the forecast horizon.

Eurozone growth drivers: strong domestic factors still to offset uncertainty and tempered global demand

01

Resilient domestic factors

Solid job creation, improving profits share, tight capacity utilization and favourable lending conditions

02

Still robust global demand

Global growth may now have peaked, but remains strong.The weakness of the euro could partly offset lower global demand

03

Ongoing trade threat

Rising protectionism and stress in emerging economies. The increase of tariffs on cars is currently frozen, but it will be negotiated again from November

04

Core inflation at low levels

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

05

Supportive economic policies

Slightly expansionary fiscal policy (likely further loosening in some countries), added to very gradual ECB's exit (no hikes until September 2019)

06

Risks intensify further

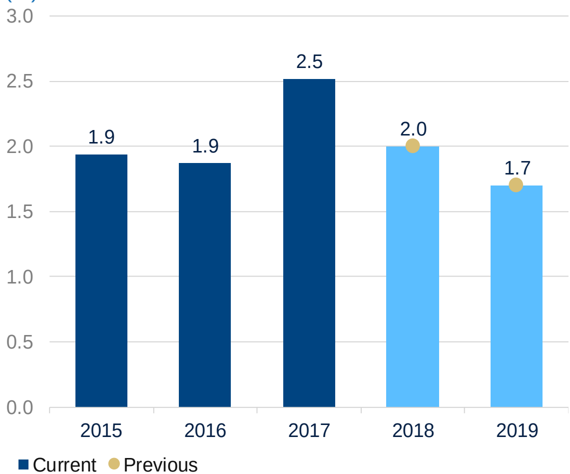
A full blown trade war and Fed's exit added to higher political uncertainty in Europe (Brexit, Italy, political stalemate in the Eurozone)

Strong domestic demand will compensate heightened uncertainty and the slowdown of global growth

- Unchanged GDP growth forecasts (2.0% in 2018 and 1.7% in 2019), but with a greater support from private consumption and investment
- Monetary and fiscal policy remains accommodative in a context of greater political uncertainty (Italy and Brexit)
- Trade tensions with the US have eased for now, but could weigh on confidence and investment
- Despite the rebound of headline inflation, core inflation will only increase gradually in 2019

Eurozone GDP growth and forecast

(%)



Main macroeconomic indicators

(% YoY, %GDP)

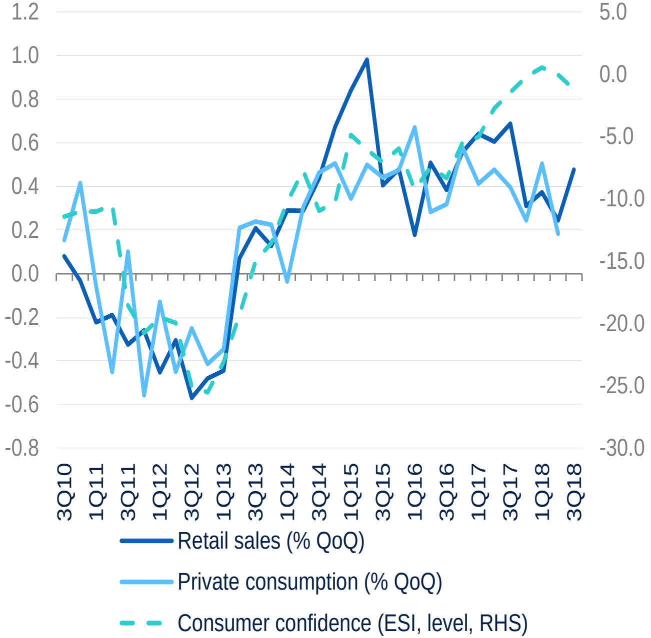
	2016	2017	2018 (f)	2019 (f)
Real GDP	**1.9**	**2.5**	**2.0**	**1.7**
Private consumption	1.9	1.7	1.4	1.6
Public consumption	1.9	1.2	1.2	1.2
Investment	3.8	2.8	3.1	3.0
Domestic demand (cont. pp)	**2.3**	**1.7**	**1.8**	**1.8**
Exports	2.9	5.5	3.1	3.6
Imports	4.1	4.1	3.0	4.1
Net exports (cont. pp)	**-0.4**	**0.8**	**0.1**	**-0.1**
Current account (% GDP)	3.2	3.2	3.1	3.0
Budget balance (% GDP)	-1.5	-0.9	-0.7	-0.8
HICP (avg. %YoY)	0.2	1.5	1.7	1.7

Source: Eurostat and BBVA Research

More moderate consumption in the short run due to lower income, but consumer mood is high and inflation should slow…

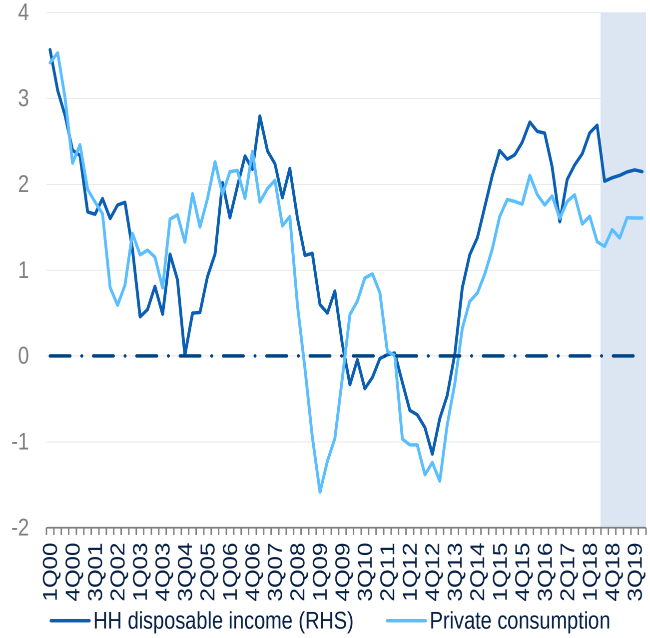
Eurozone: private consumption, retail sales and ESI consumer confidence

(%; QoQ; level)



Eurozone: private consumption and real labour income

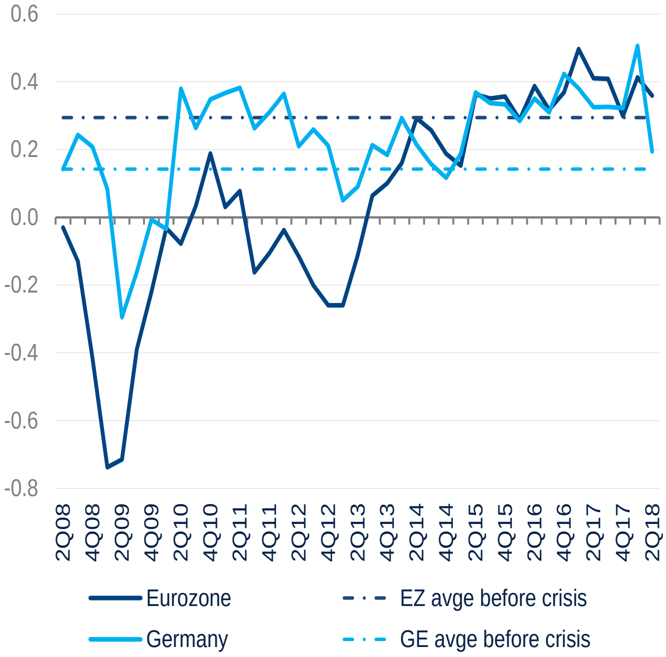
(% YoY)



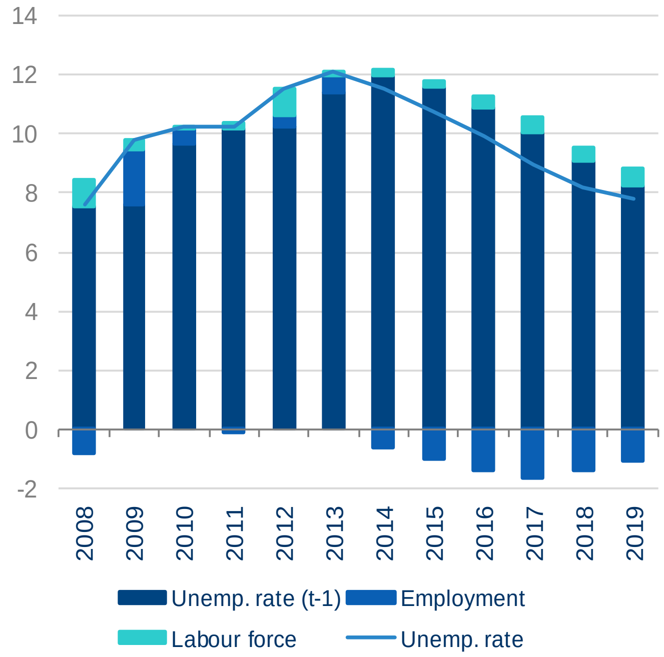
Source: Eurostat and BBVA Research

… along with strong job creation

Eurozone: employment
(%; QoQ)



Eurozone: unemployment rate and contributions
(%, pp)

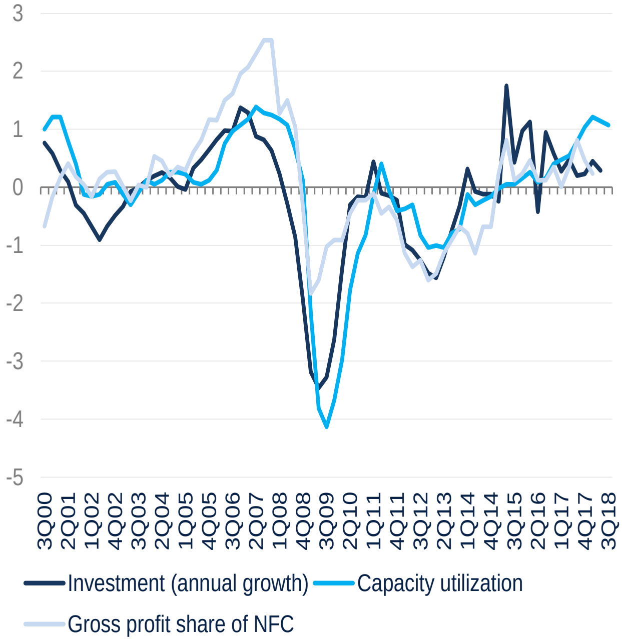


Source: Eurostat and BBVA Research

Firms' supply constraints, higher profits and financial conditions should continue to support a solid recovery of investment

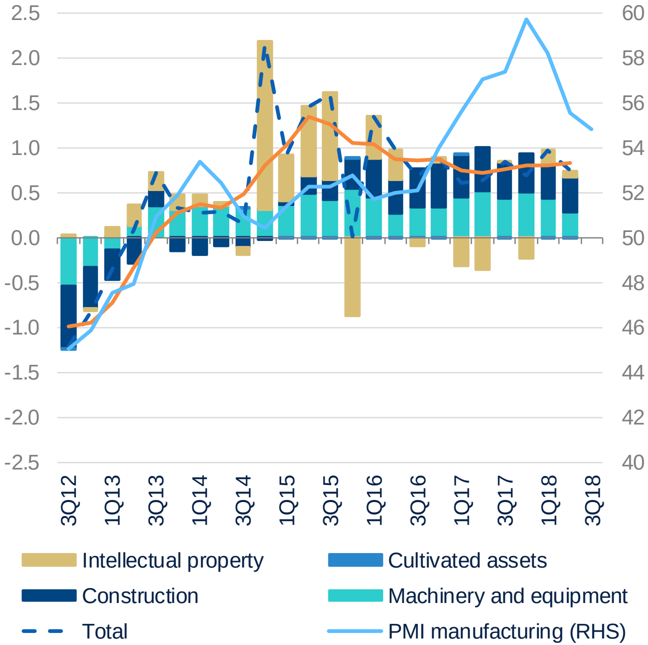
Investment, capacity utilization and profit share

(normalized)



Eurozone: investment and confidence

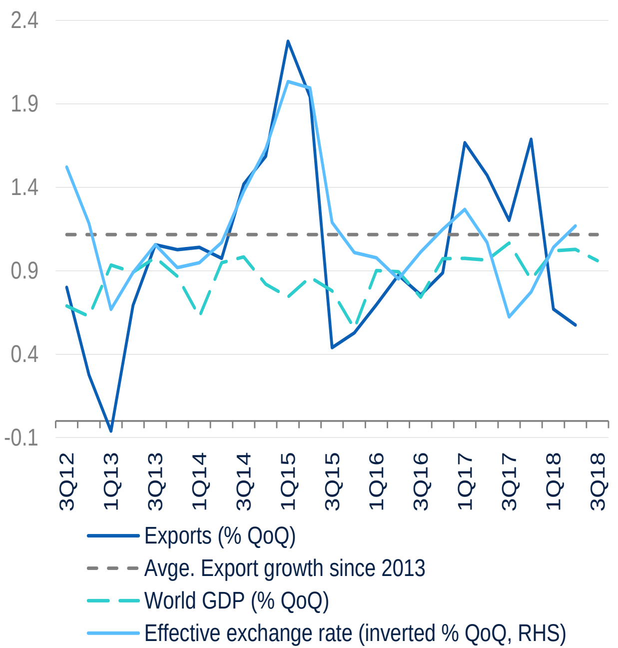
(% smooth QoQ; level)



Source: Eurostat and BBVA Research

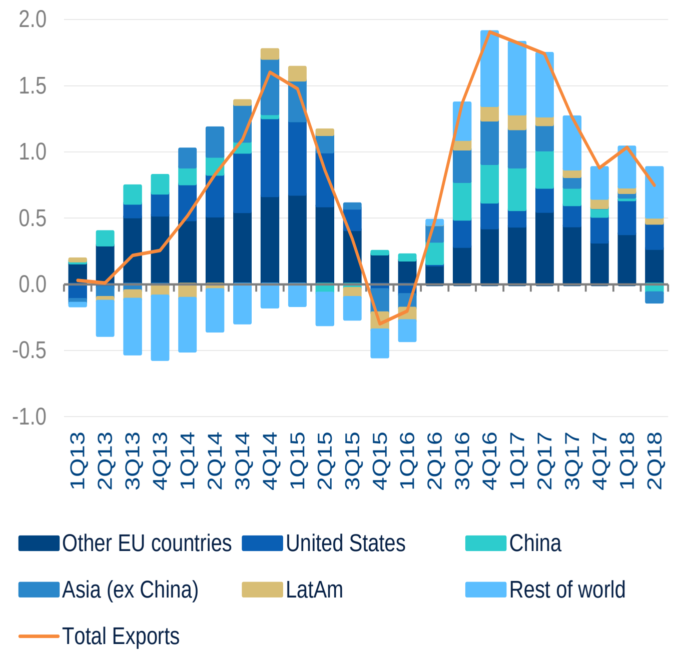
Exports slowed in 1S18 after a strong 2017, but they will benefit from a weaker euro and global demand

Eurozone: exports (national accounts), EURUSD and World GDP



Eurozone: exports by destination

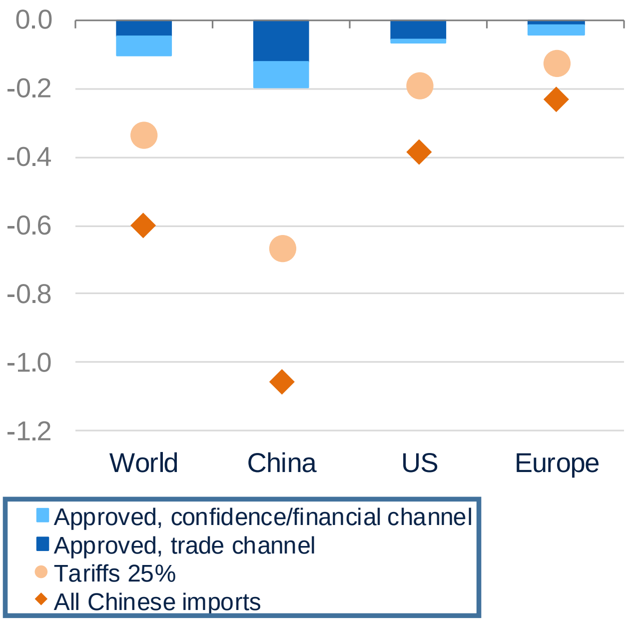
(trade balance; % smooth QoQ)



Source: Eurostat and BBVA Research

US and China have raised tariffs, but the estimated effect on global growth is limited so far

Effect of US tariff increases and other countries' responses on GDP growth
(2018-20, pp)

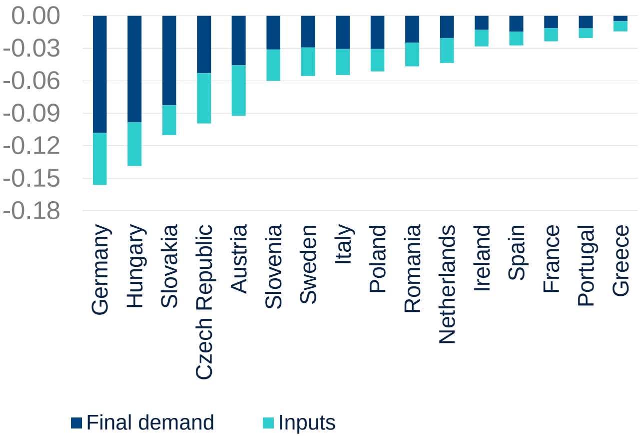


- The expected direct effect (trade channel) from measures approved up to now will likely remain limited, but indirect effects could be sizeable, especially for China and emerging economies
- Agreement on USMCA reduces uncertainty for Mexico and Canada, although ratification is still pending
- In Europe, tariff increases on autos have been put on hold, but they will be negotiated from November onwards

Source: BBVA Research and Bloomberg

The risk of an increase in US tariffs to the European automotive sector continues, with a limited and different effect across countries

Effect on GDP growth of US tariff increases to the European automotive sector (2018-20, pp)



- An increase of the tariff to the European automotive sector up to 20% (current 2.5%) could subtract between one and two tenths of the growth of Germany and the northern European countries
- Greater impact in Korea and Japan, but also in the US
- There is uncertainty about the effect of the hardening the amount of inputs produced in North America (75%) in the USMCA by European car companies, but the impact should be smaller

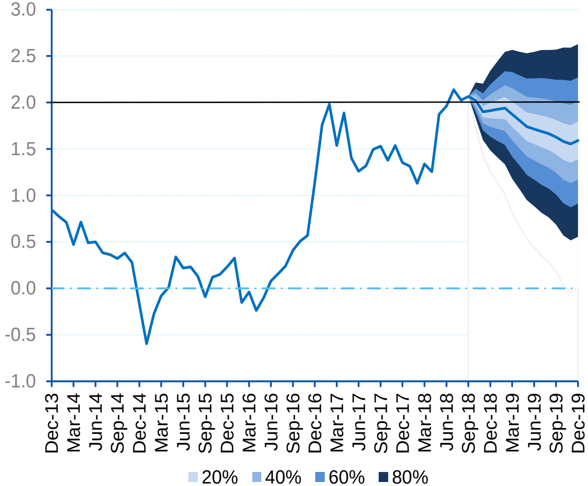
Simulation: increase of tariffs to 20% to the European automotive sector, Japan and Korea in addition to the measures approved so far
Source: BBVA Research

Rising oil prices could keep inflation around 2% for the remainder of the year, but core inflation remains at low levels

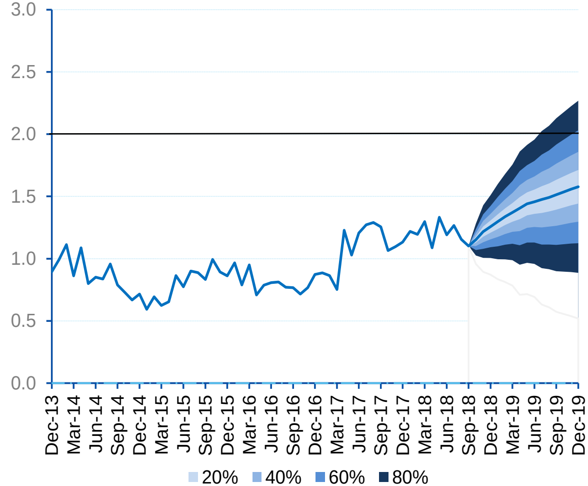
- No major changes in our assessment on inflation. Higher annual rates in the short-term due to oil price increase. Reaching an average of 1.7% in 2018-19

- Beyond volatility in recent months, we continue to expect a gradual upward trend in core inflation driven by incipient signs of inflationary pressures stemming from input prices and a tighter labour market (average of 1.2% and 1.5% in 2018-19)

HICP headline inflation and forecast
(% YoY)



HICP core inflation and forecast
(% YoY)



Source: BBVA Research

The ECB on track on normalization process. QE will end in December 2018, rates on hold until September 2019

QE

- The ECB (and we) anticipate that:
  - The **QE to end in December 2018** after reducing monthly purchases to EUR15bn per month since September
  - Full **reinvestment** of maturing securities **until at least December 2020**

Interest rates

- The ECB is **anchoring rate hike expectations through strong forward guidance** "[*key interest rates]To remain at their present levels at least through the summer of 2019 […] as long as necessary"*
- We expect **depo rate hike** (+15bps) in **September 2019** and **depo and refi hike (+25bps) in December 2019**.

The widely expected normalization faces growing risks

Global factors

Protectionism
Emerging Markets
Financial market volatility

Domestic factors

Risks to growth outlook tilted to the downside

Renewed concerns on the fiscal side and debt markets

Germany: Growth forecasts unchanged but the outlook has deteriorated ahead of the possibility of tougher auto tariffs

Main macroeconomic indicators
(% YoY, %GDP)

	2016	2017	2018 (f)	2019 (f)
Real GDP	**2.2**	**2.5**	**1.9**	**1.7**
Private consumption	1.9	2.0	1.4	1.6
Public consumption	4.0	1.6	1.2	1.8
Investment	3.4	3.6	3.4	3.1
Domestic demand (cont. pp)	**2.8**	**2.1**	**1.8**	**1.8**
Exports	2.1	5.3	3.1	3.6
Imports	4.0	5.3	3.5	4.5
Net exports (cont. pp)	**-0.6**	**0.3**	**0.0**	**-0.2**
Current account (% GDP)	8.4	7.9	7.7	7.2
Budget balance (% GDP)	1.0	1.3	1.3	1.3
HICP (avg. %YoY)	0.4	1.7	1.9	1.8

Source: Eurostat and BBVA Research

- GDP growth forecasts for 2018 and 2019 remain unchanged despite sluggish exports and consumption during 2Q18
- Soft data suggest that the manufacturing slowdown could have halted and that private consumption should pick up in coming quarters
- Local risks: The possibility of a hard Brexit and of tougher conditions for auto exports is starting to weigh on confidence. Bavarian elections have also put in evidence the fragility of Merkel’s coalition government

France: Economic growth will moderate in a more uncertain domestic and international environment

Main macroeconomic indicators
(% YoY, %GDP)

	2016	2017	2018 (f)	2019 (f)
Real GDP	**1.1**	**2.3**	**1.6**	**1.7**
Private consumption	1.9	1.2	0.9	1.2
Public consumption	1.4	1.4	1.1	1.5
Investment	2.7	4.7	2.9	2.8
Domestic demand (cont. pp)	**1.6**	**2.2**	**1.4**	**1.7**
Exports	1.5	4.7	3.2	3.3
Imports	3.1	4.1	2.3	3.2
Net exports (cont. pp)	**-0.5**	**0.1**	**0.2**	**0.0**
Current account (% GDP)	-0.8	-0.6	-0.6	-0.6
Budget balance (% GDP)	-3.4	-2.6	-2.5	-2.6
HICP (avg. %YoY)	0.3	1.2	1.9	1.7

Source: Eurostat and BBVA Research

- We revised downwards GDP growth forecasts for 2018 to 1.6% (-0.2pp) and upwards for 2019, to 1.7% (+0.1pp)
- Tax cuts are expected to lift household purchasing power giving a boost to private consumption
- Lower exports will drag economic growth in 2018, but net exports will remain contributing positively this year to turn neutral in 2019
- Local risks: fiscal consolidation and reforms (tax and social security contributions cuts) could end in the run-up to 2020. In addition, Macron's government is raising uncertainty

Italy: The ability to pass a expansionary budget without affecting financial markets will condition growth in the short term

Main macroeconomic indicators
(% YoY, %GDP)

	2016	2017	2018 (f)	2019 (f)
Real GDP	**1.3**	**1.6**	**1.1**	**1.1**
Private consumption	1.3	1.5	0.9	1.0
Public consumption	0.3	-0.1	0.1	0.5
Investment	3.7	4.4	3.9	2.1
Domestic demand (cont. pp)	**1.6**	**1.3**	**1.2**	**1.1**
Exports	2.3	6.3	1.4	3.1
Imports	3.8	5.6	1.9	3.2
Net exports (cont. pp)	**-0.4**	**0.3**	**-0.1**	**0.0**
Current account (% GDP)	2.5	2.8	2.5	2.4
Budget balance (% GDP)	-2.5	-2.3	-1.9	-2.4
HICP (avg. %YoY)	-0.1	1.3	1.3	1.7

Source: Eurostat and BBVA Research

- We maintain GDP growth forecast for 2018 unchanged at 1.1% and revise 2019 to the downside (-0.1pp) to 1.1%
- Investment growth will keep fuelling the economic expansion, despite lower contribution compared to last year
- Private consumption will likely be supported by expansionary fiscal plans, including flat tax rate, reform of the pension system and greater unemployment benefits
- Local risks are mainly concentrated on the ability of the Government to pass the budget without disturbing financial markets

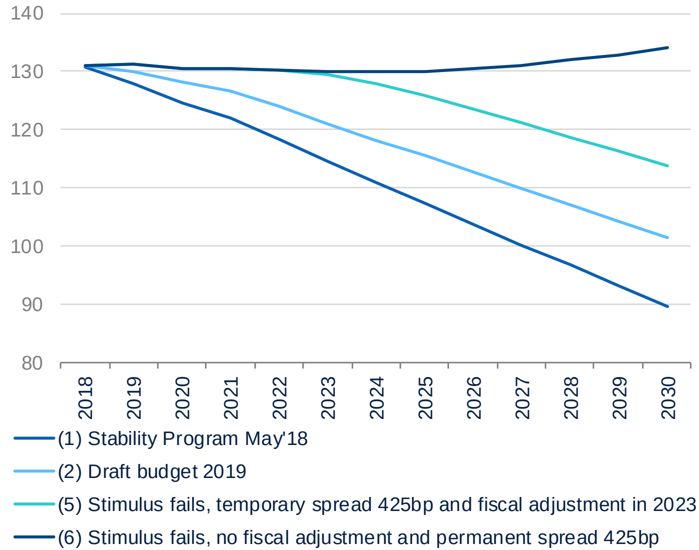
Italy Draft Budget 2019: Sustainable debt, but more vulnerable and less room for maneuver if fiscal adjustment postponed

Budget balance variation between SP'18 and DB'19 after new measures (as % of GDP)

	2019		2020		2021	
	SP'18	**DB'19**	SP'18	**DB'19**	SP'18	**DB'19**
Budget balance	-0.8	**-2.4**	0.0	**-2.1**	0.2	**-1.8**
Lower growth and high interest rate	-0.40		-0.70		-0.50	
Sterilization of safeguard clauses (VAT)	-0.68		-0.29		-0.21	
Flat tax	-0.03		-0.10		-0.07	
Reform of pension	-0.37		-0.37		-0.36	
Citizenship income	-0.37		-0.36		-0.35	
Boosting investment	-0.19		-0.30		-0.33	
Rest	0.44		-0.01		0.02	
Total	-1.60		-2.13		-1.80	

SP'18: Stability Program May 2018
DB'19: Draft Budget 2019
Source: Italian Ministry of Economy and Finance and BBVA Research

Italy: Public debt (as % of GDP)



Source: European Commissionand BBVA Research

Spain: Further slowdown going forward, but under a solid expansion of domestic demand

Main macroeconomic indicators
(% YoY, %GDP)

	2016	2017	2018 (f)	2019 (f)
Real GDP	**3.2**	**3.0**	**2.6**	**2.4**
Private consumption	2.8	2.5	2.4	1.8
Public consumption	1.0	1.9	2.3	2.3
Investment	2.9	4.8	6.0	5.0
Domestic demand (cont. pp)	**2.4**	**2.9**	**3.1**	**2.5**
Exports	5.2	5.2	2.8	5.7
Imports	2.9	5.6	4.7	6.2
Net exports (cont. pp)	**0.8**	**0.1**	**-0.5**	**0.0**
Current account (% GDP)	1.9	1.9	1.4	1.3
Budget balance (% GDP)	-4.3	-3.1	-2.8	-2.1
HICP (avg. %YoY)	-0.2	2.0	1.8	1.6

Source: Eurostat and BBVA Research

- GDP growth forecasts are revised downwards to 2.6% (-0,3pp) and 2.4% (-0,1pp) in 2018 and 2019
- Changes in demand composition, with consumption and exports being hit by diminishing pent-up demand and lower tourism exports, respectively
- On the other hand, the projected monetary and fiscal expansion will likely fuel in investment growth further
- Political uncertainty and the risk of contagion from Italy's expansionary fiscal policies remain as the risks

BBVA Research

Eurozone Economic Watch

October 2018

Creando Oportunidades