BBVA Research

Eurozone Economic Watch

January 2019

Creando Oportunidades

Eurozone | Downward GDP growth revision due to increasing uncertainty and global headwinds

- EZ growth slowed more than expected in 2H18 to around 0.2% QoQ as easing global support was exacerbated by some temporary country and sector specific factors. As a result, GDP could slow to 1.8% in 2018 after 2.5% in 2017.
- Hard data up to November were mixed. Industrial production declined further as the recovery in capital goods (more related to investment) lost steam. However, nominal exports maintained a very gradual recovery while retail sales picked up, halting the marked slowdown observed in previous quarters.
- Worsening confidence keeps taking root in early 2019, not just in manufacturing but also spreading to services, except in Germany, in turn increasing concerns about the negative effect of protracted uncertainty on private spending. However, consumer confidence seems to have stabilized.
- We revise downwards growth forecasts to 1.4% in both 2019 and 2020 mainly driven by the poor performance in 2H18 but also due to lower global demand, which along with increasing uncertainty (Brexit, political hurdles in some member states) could put a brake on investment. Lower oil prices and the depreciation of the euro could support growth in addition to solid domestic drivers and somewhat more accommodative fiscal and monetary policies.
- The sharp fall of oil Brent will shape inflation down in coming months, clearly below the ECB's target in 2019-20, while core inflation is likely to trend upwards very gradually.
- Risks are tilted to the downside, mostly related to political events. The more imminent is related to Brexit, but also increasing political polarisation across member states and the lack of progress in the integration process on the eve of European Parliament elections. In addition, US threats on higher tariffs to the auto sector could not be ruled out.

01

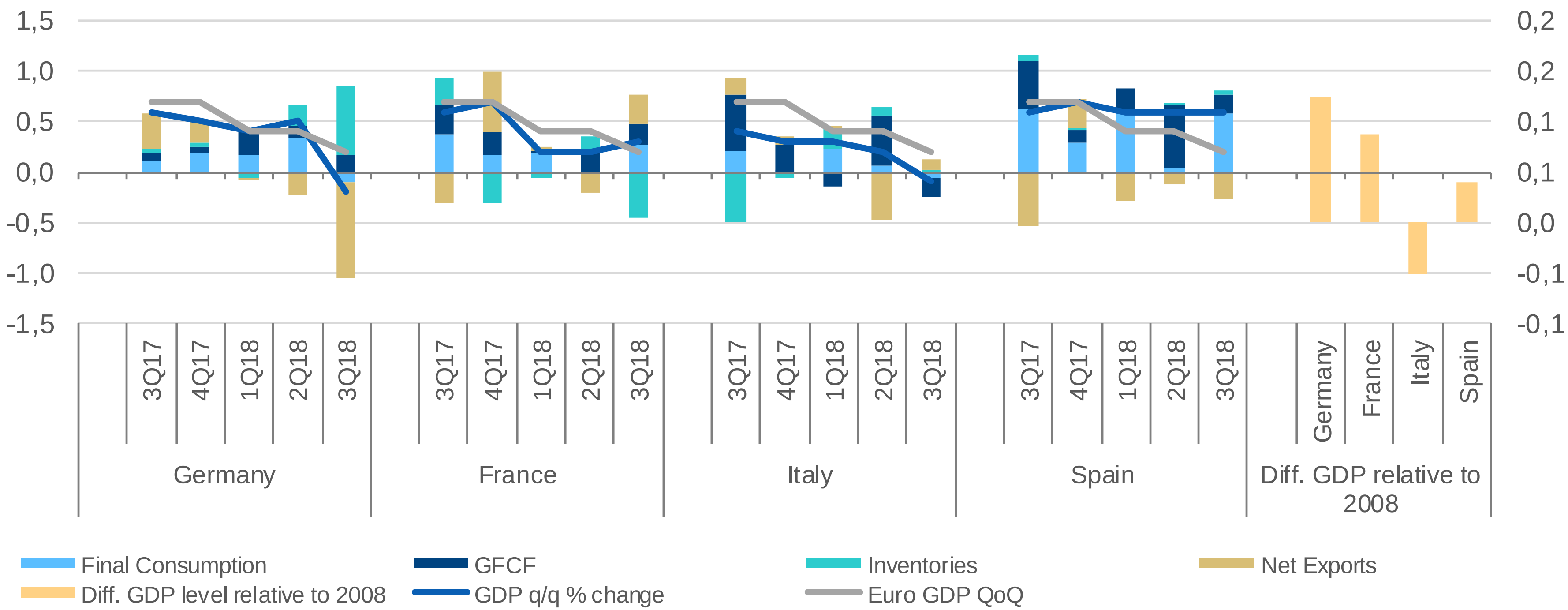
Economic developments

Larger-than-expected slowdown in 3Q18 driven by one-off effects in Germany, but also by the Italian GDP contraction

Regulatory changes in the car industry partly explain the fall in output, especially in Germany, but also lower global demand. In contrast, growth rebounded in France and remained steady in Spain.

GDP and expenditure contribution by country

(%QoQ, pp)



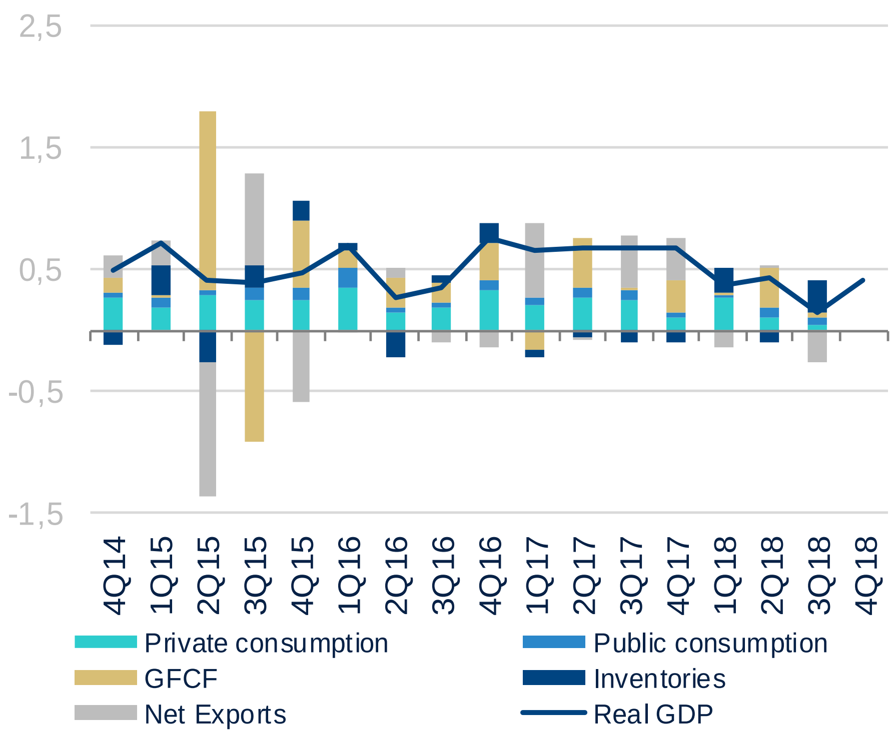
Source: Eurostat and BBVA Research

GDP growth to remain around 0.2% QoQ in 4Q18, as net exports continue to put a brake on activity along with lingering one-off factors

Some temporary factors should be fading, but French riots could have also weighed on growth late last year. In addition, there are more enduring drivers such as lower global demand that suggest more moderate growth could take root in coming quarters.

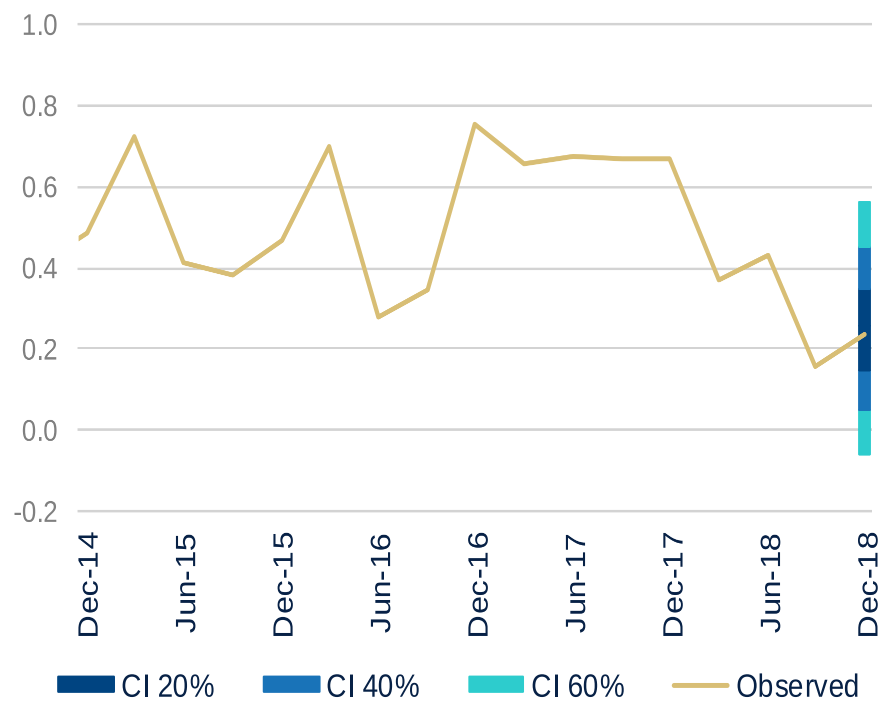
GDP, contribution by components

(%, QoQ)



GDP and MICA forecasts

(%, QoQ)

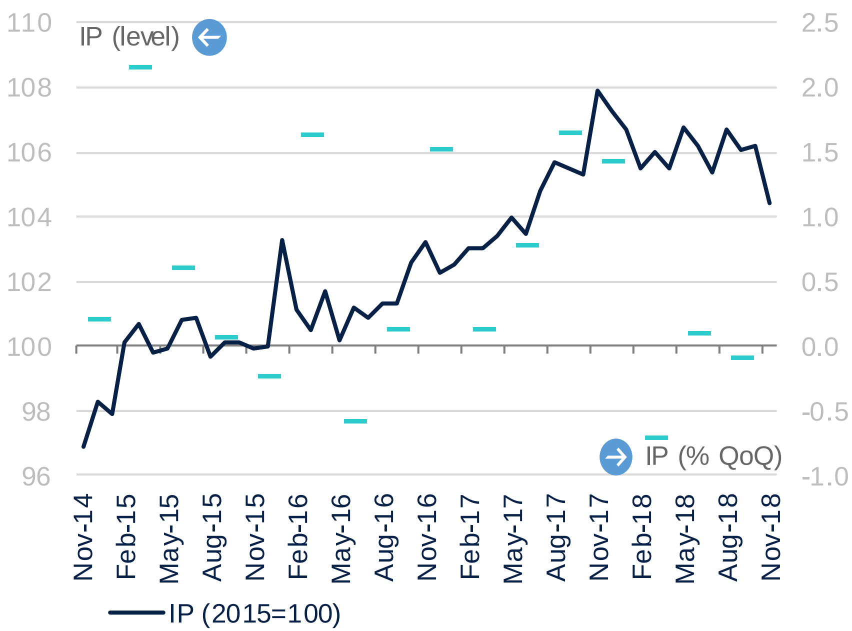


Source: Eurostat and BBVA Research

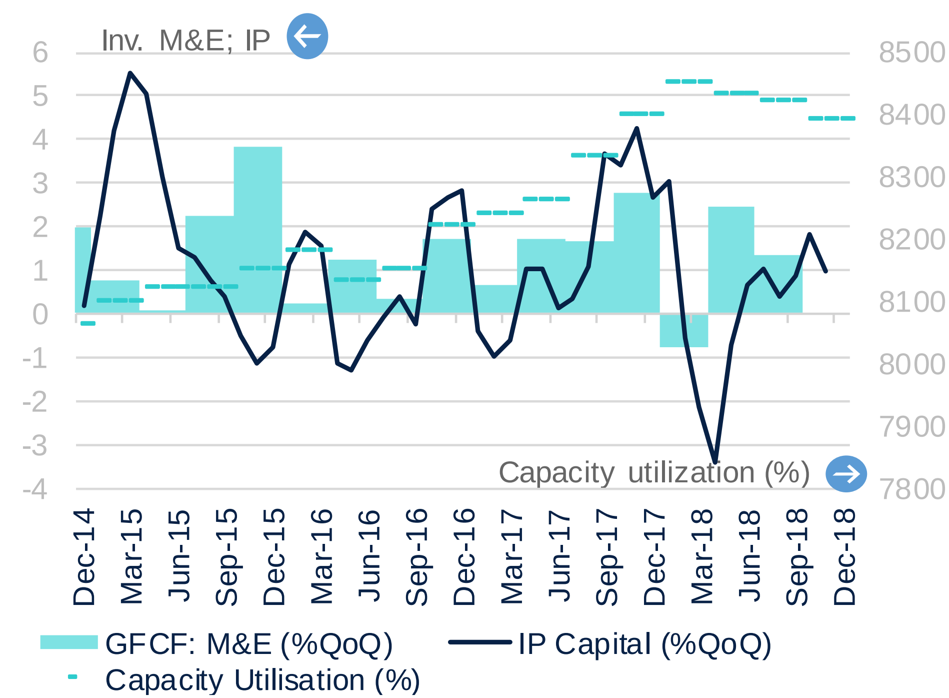
Industrial production fell in November across the board, suggesting that the investment recovery could lose some steam in coming quarters

The decline was broad-based across industrial groupings with capital and durable consumer goods leading the slip, increasing doubts about the sustainability of the modest recovery since mid-2018.

Industrial production
(Level, % QoQ)



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

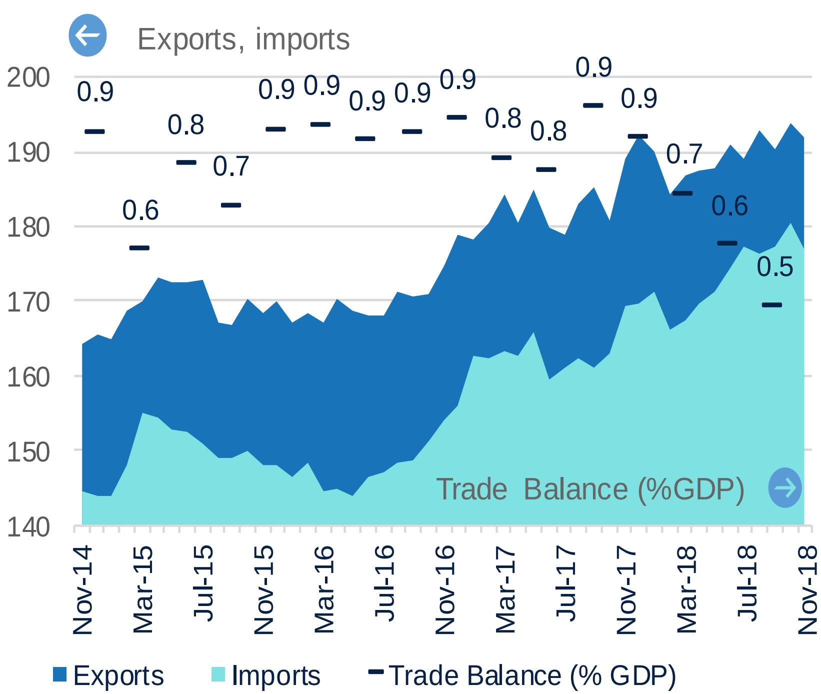


Source: Eurostat and BBVA Research

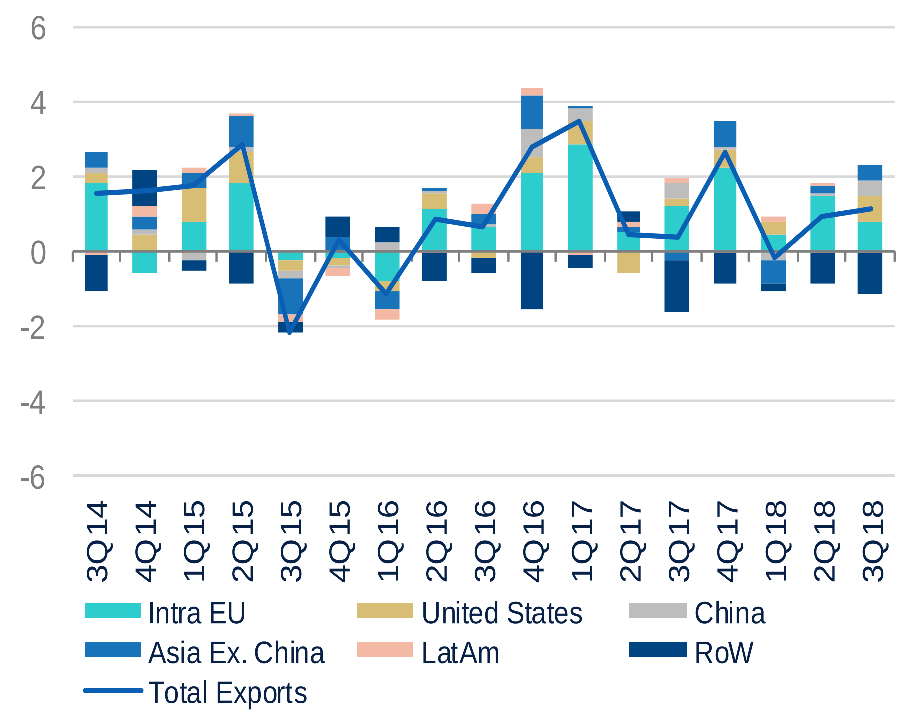
Very gradual recovery in nominal exports up to November, but more dynamic imports could be reflected in a new drag on net exports

Beyond volatility, exports have increased gradually since the second quarter of 2018, but their contribution to growth continues to ease after the strong boost a year earlier.

Trade balance
(€bn; %GDP)



Exports by destination
(%YoY; pp)

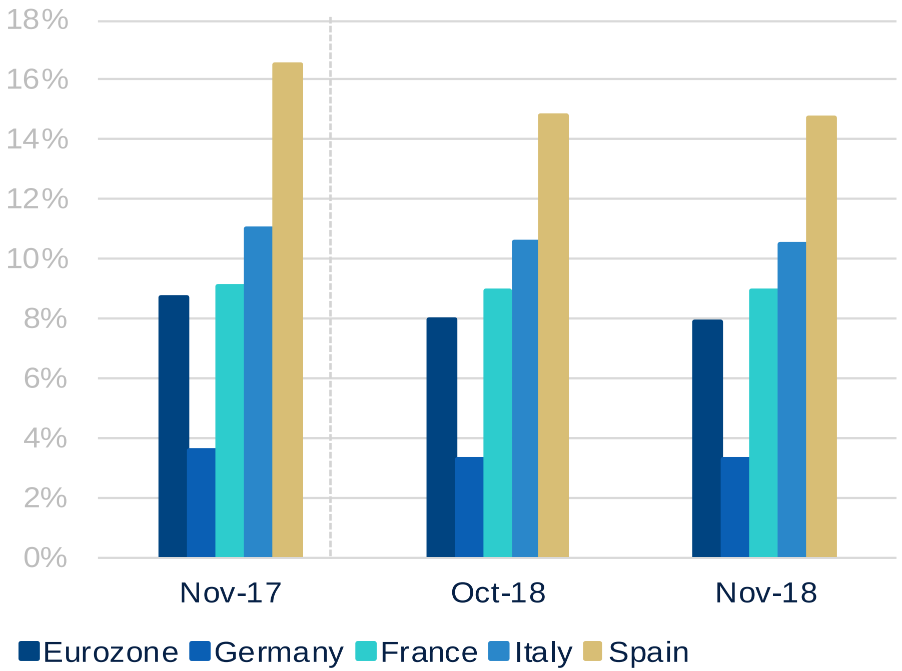


Source: Eurostat and BBVA Research

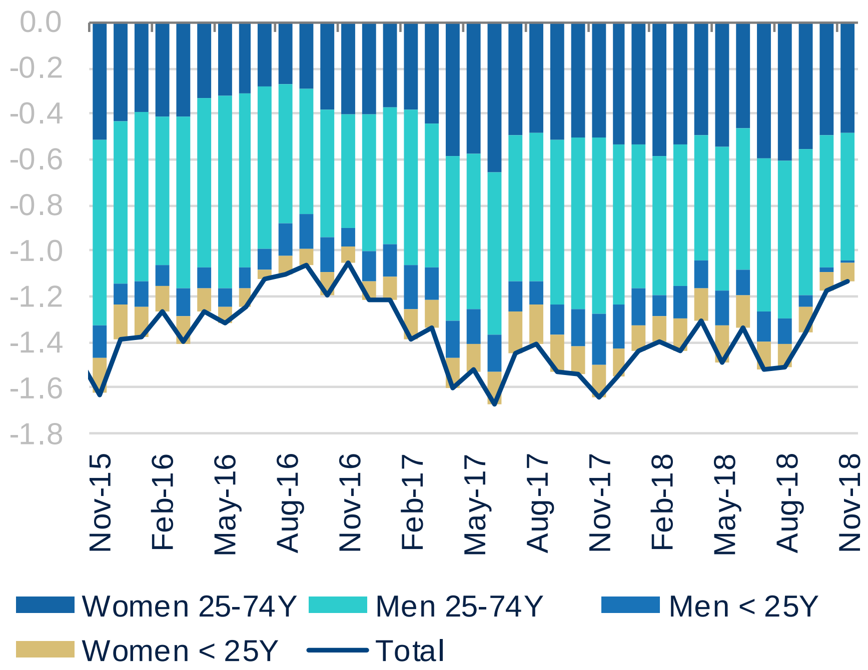
The unemployment rate remained broadly unchanged in November

Despite significant differences across countries, the tightening of the market could put some upward pressure on wages in coming quarters.

Unemployment rate by country
(%)



Annual unemployment change by gender and age
(millions)



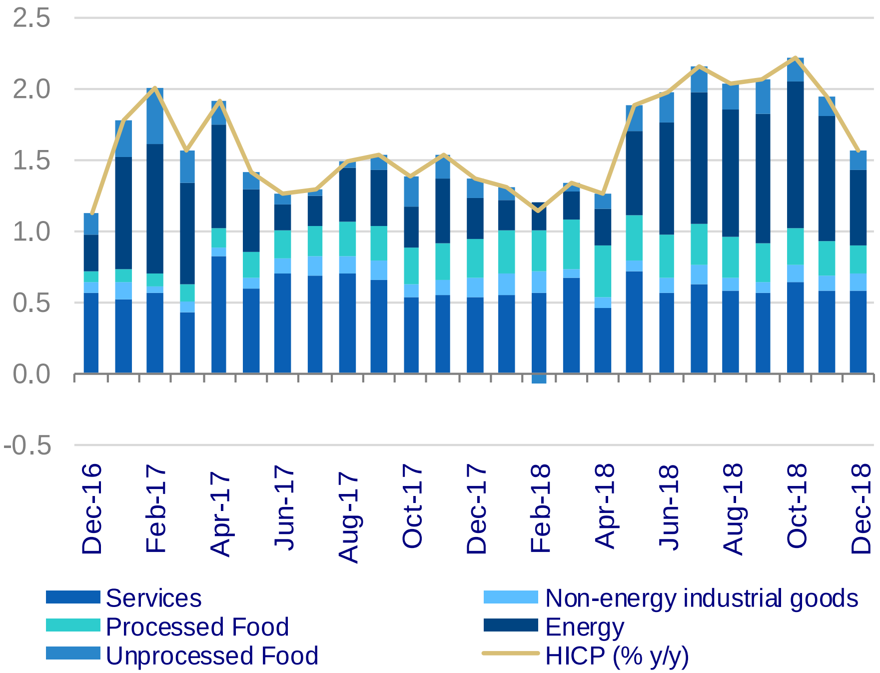
Source: Eurostat and BBVA Research

Slowing headline inflation driven by lower oil prices and steady core inflation at low levels

The sharp fall of Brent oil prices will tilt inflation down in coming months, to levels clearly below the ECB's target, while core inflation is likely to trend upwards very gradually.

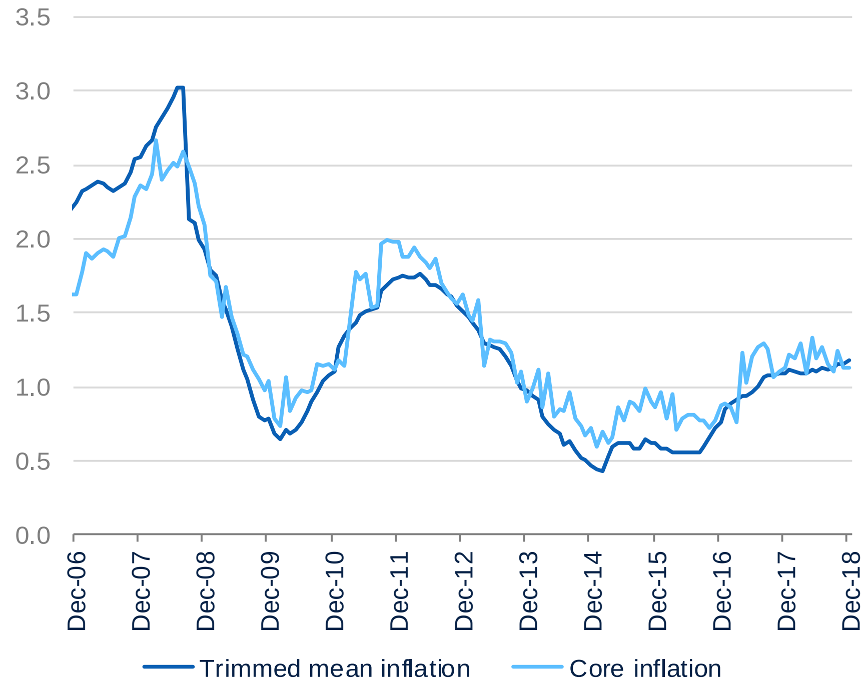
Inflation contribution of components

(%YoY, pp)



Core and trimmed-mean inflation

(%YoY; pp)

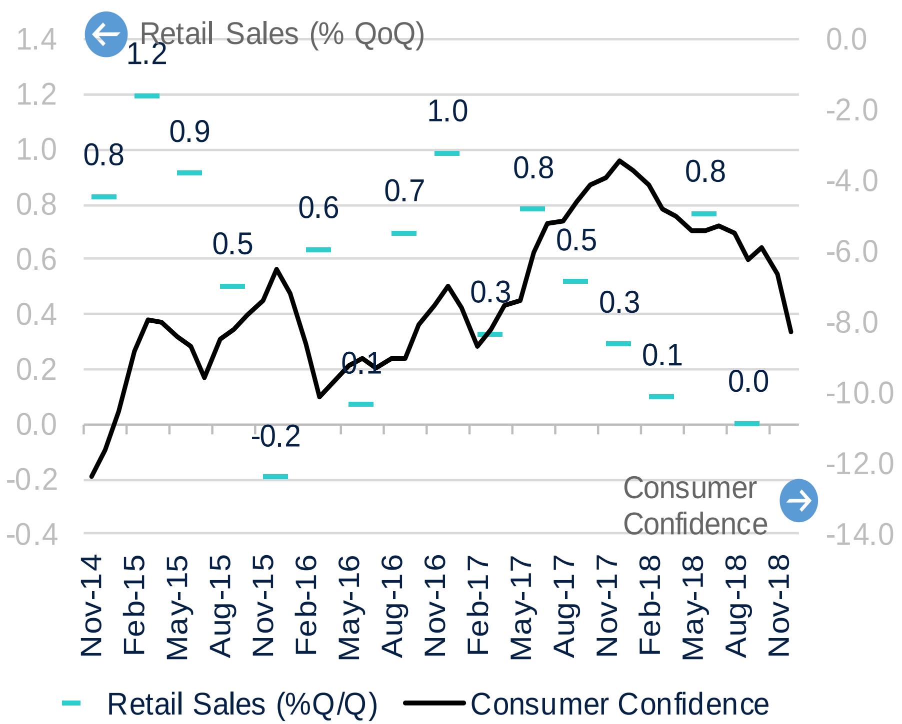


Source: Eurostat and BBVA Research

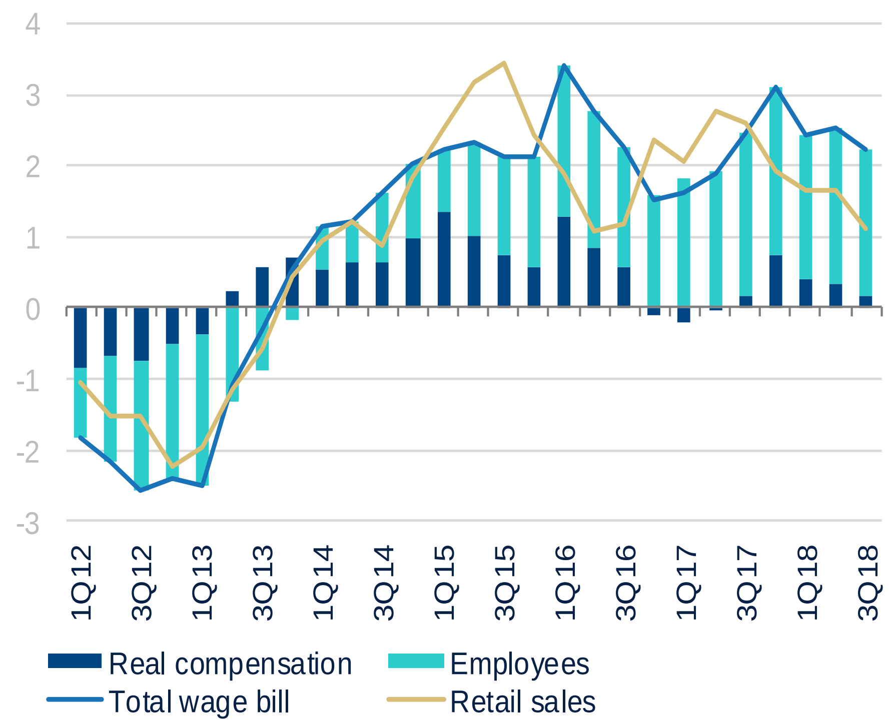
Retail trade increased in November, halting the marked slowdown in recent quarters

Lower inflation and higher wages will continue to support households' spending, although likely at a more moderate pace since November's figures partly reflect the Black Friday's effect.

Retail sales and consumer confidence
(%QoQ, level)



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



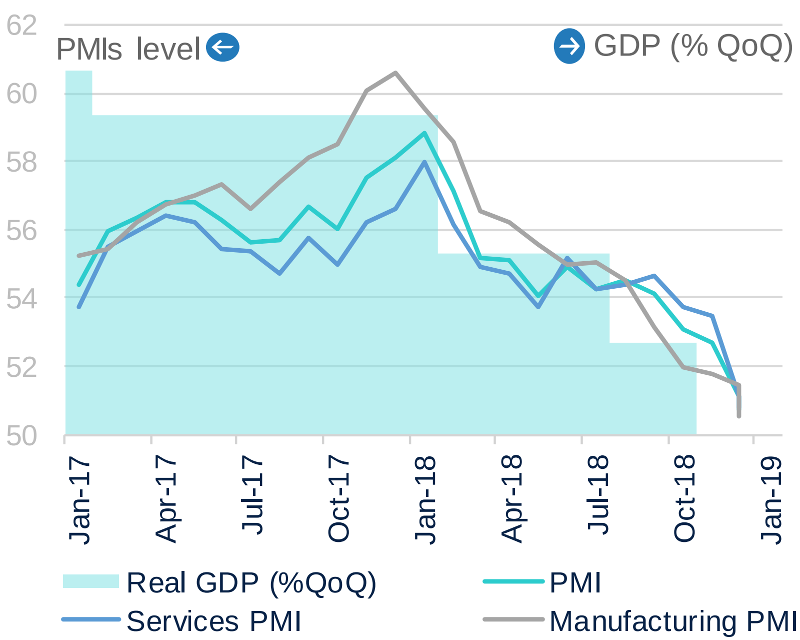
Source: Eurostat and BBVA Research

Worsening confidence in both manufacturing and services continues in early year, but consumer confidence improved slightly

Protracted concerns about protectionism and lower global demand, especially in China, is weighing on confidence in manufacturing and it is spreading to services. However, consumer confidence seems to have stabilized supported by the strength of domestic drivers and lower inflation.

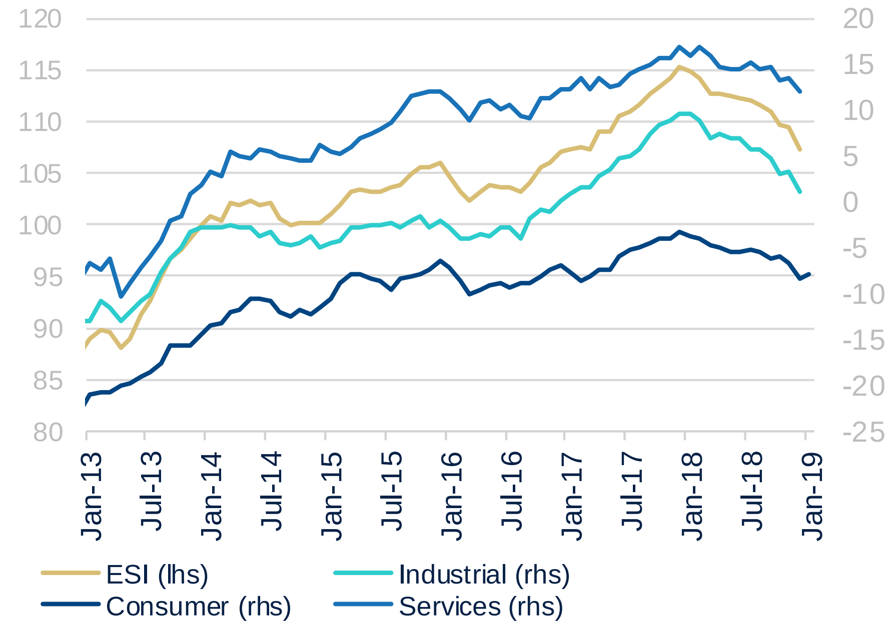
PMI and GDP

(level, %QoQ)



EC confidence survey

(level)

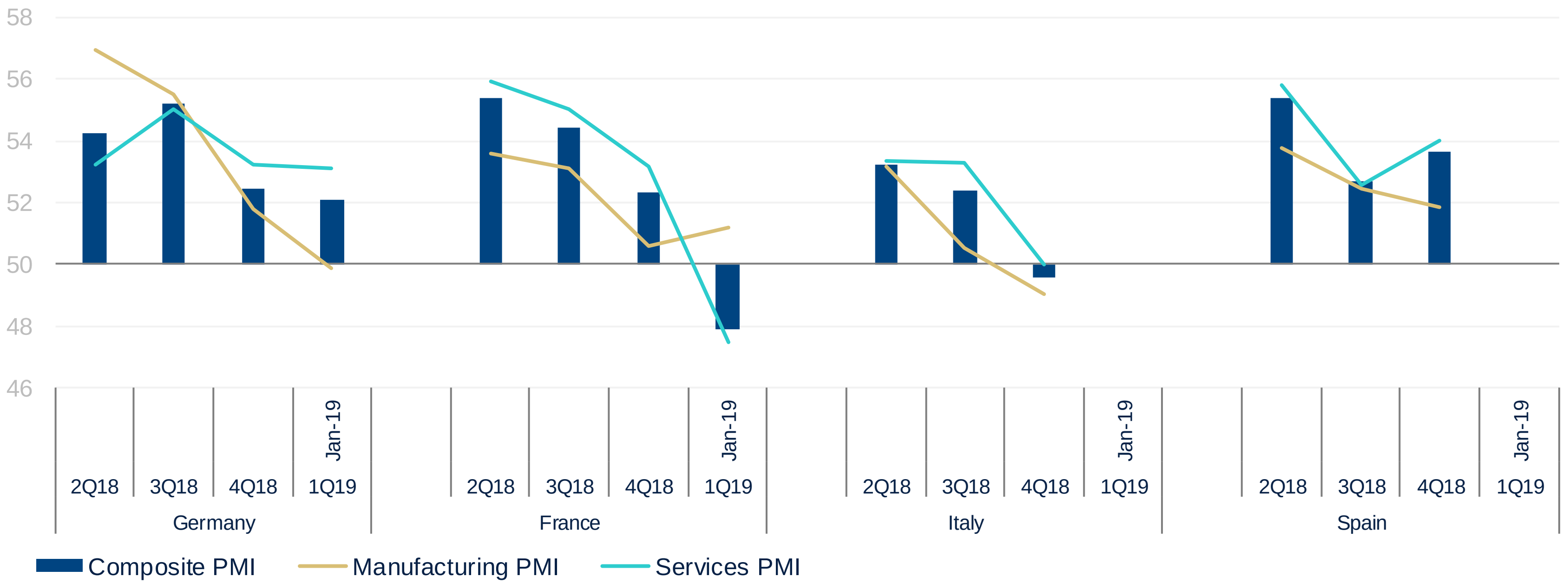


Source: Eurostat and BBVA Research

In January PMIs fell in France and recovered slightly in Germany due to a strong expansion in the service sector

German data reflects higher concerns about the impact of lower global demand in manufacturing and contrasts with the resilience of services supported by healthy domestic factors. French economy seems to be less exposed to external shocks, but protests are hindering service confidence.

PMI Survey
(level)



Source: Markit and BBVA Research

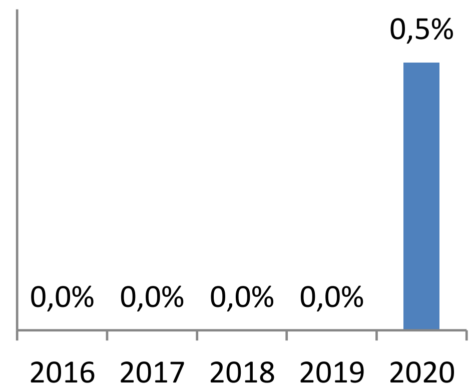
The ECB on track on normalization process, but rate hikes are likely to be delayed as downward risks to growth have increased

Balance

- **The QE ended in Dec18**
- **Enhanced forward guidance on reinvestment:** to continue well beyond the start of interest rate hikes
- **Liquidity:** another TLTRO before Jun19 is likely to be announced to avoid liquidity cliff in 2020.

Interest rates

- **Delay in the rate** hike path due to a less supportive global outlook and higher risks.
- **First depo rate hike (+10bps) in** Dec19. **First refi rate hike (+25bps) in Jun20**



02

Updated forecasts

Eurozone growth drivers: solid domestic drivers beyond one-off factors, but increasing political uncertainty and global headwinds

01

Worse-than-expected data in 2H18

Partly due to one-off factors, but also more permanent ones related to lower global demand and protracted uncertainty

02

Slightly faster global slowdown, but still robust

External support is fading, but our scenario envisages a global growth soft landing as China's growth stabilizes along with easing geopolitical uncertainty

03

Lower oil prices and headline inflation

Further support to domestic demand, while core inflation is likely to increase only very gradual due to tightening labour market

04

Resilient domestic factors

Labour market improvement, households' disposable income, tight capacity utilization and favourable lending conditions

05

Supportive economic policies

Slightly expansionary fiscal policy (further loosening in some countries), added to very gradual ECB's exit (no refi hikes until Jun'20)

06

Risks intensify further

A full blown trade war and a larger slowdown in China and the EU add to higher political uncertainty in Europe (Brexit, Italy, political stalemate in the Eurozone)

Eurozone will trend faster to potential growth as external support fades away

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018 (e)	2019 (f)	2020 (f)
Real GDP	**2.5**	**1.8**	**1.4**	**1.4**
Private consumption	1.7	1.3	1.5	1.5
Public consumption	1.2	1.0	1.4	1.2
Investment	2.9	3.3	2.9	2.4
Domestic Dem. (cont. pp)	**1.7**	**1.8**	**1.7**	**1.6**
Exports	5.4	3.0	3.1	3.0
Imports	4.1	3.1	4.0	3.6
Net Exports (cont. pp)	**0.8**	**0.1**	**-0.3**	**-0.2**
Current account (% GDP)	**3.1**	**2.9**	**2.7**	**2.5**
Budget balance (% GDP)	**-1.0**	**-0.6**	**-0.9**	**-0.9**
HICP (avg. %YoY)	**1.5**	**1.7**	**1.6**	**1.6**

Source: BBVA Research

- Lower oil prices bolster the strength of domestic drivers, but not enough to offset the drag of net exports, despite the euro depreciation
- More supportive monetary and fiscal policy could help to prevent the effect of worsening confidence on private spending
- The sharp fall in oil prices will shape inflation down clearly below the ECB's target earlier this year, but core inflation should increase very gradually
- Domestic risks tilted to the downwards and predominantly political (Brexit, political uncertainty)

Germany: Significant downward revision after larger-than-expected effect of transitory factors but also due to lower global demand

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018 (e)	2019 (f)	2020 (f)
Real GDP	**2.5**	**1.5**	**1.3**	**1.4**
Private consumption	2.0	1.0	1.4	1.4
Public consumption	1.6	1.1	1.8	1.5
Investment	3.6	4.8	3.4	2.6
Domestic Dem. (cont. pp)	**2.1**	**1.7**	**1.8**	**1.6**
Exports	5.3	2.4	2.9	2.7
Imports	5.3	3.4	4.5	3.5
Net Exports (cont. pp)	**0.3**	**-0.3**	**-0.5**	**-0.2**
Current account (% GDP)	**8.0**	**7.5**	**7.1**	**6.7**
Budget balance (% GDP)	**1.0**	**1.6**	**1.2**	**0.9**
HICP (avg. %YoY)	**1.7**	**1.9**	**1.7**	**1.7**

Source: BBVA Research

- The change in regulation of the automobile sector in Germany hindered the economic activity in 2H18, leading the country to a sharp slowdown
- Domestic fundamentals remain solid (low unemployment, pick-up in wages, low inflation, slightly expansionary fiscal policy, favourable financing conditions). Increasing support from both private and public consumption…
- … but investment likely to be hampered by increasing uncertainty on global trade. Net exports are expected to weigh on activity over the forecast horizon

France: Fiscal stimulus expected to underpin domestic demand and restrain the slowdown

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018 (e)	2019 (f)	2020 (f)
Real GDP	**2.3**	**1.5**	**1.6**	**1.5**
Private consumption	1.2	0.9	1.2	1.3
Public consumption	1.4	1.0	1.3	1.4
Investment	4.7	3.0	2.9	2.5
Domestic Dem. (cont. pp)	**2.2**	**0.9**	**1.6**	**1.5**
Exports	4.7	2.8	2.8	2.6
Imports	4.1	0.9	2.6	2.5
Net Exports (cont. pp)	**0.1**	**0.6**	**0.0**	**0.0**
Current account (% GDP)	**-0.6**	**-0.7**	**-0.6**	**-0.6**
Budget balance (% GDP)	**-2.7**	**-2.6**	**-3.2**	**-2.2**
HICP (avg. %YoY)	**1.2**	**2.1**	**1.5**	**1.6**

- The “gilets jaunes” protests could be weighing on growth since late 2018
- But some measures announced (tax cuts) along with lower inflation are expected to stimulate domestic demand
- Government’s support package could impair public deficit to above 3% of GDP in 2019
- Despite the resilience of exports, the boost from net exports last year is expected to fade away over the forecast horizon, while investment should lose some steam gradually

Source: BBVA Research

Italy: Slowdown to take root as fundamentals weaken further and political uncertainty takes its toll

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018 (e)	2019 (f)	2020 (f)
Real GDP	**1.6**	**0.9**	**0.4**	**0.9**
Private consumption	-0.1	0.1	0.4	0.5
Public consumption	4.4	3.8	1.0	1.6
Investment	4.4	3.8	1.0	1.6
Domestic Dem. (cont. pp)	**1.3**	**1.1**	**0.4**	**0.9**
Exports	6.3	0.8	2.7	2.7
Imports	5.6	1.8	3.0	2.6
Net Exports (cont. pp)	**0.3**	**-0.3**	**-0.1**	**0.1**
Current account (% GDP)	**2.8**	**2.5**	**2.3**	**2.4**
Budget balance (% GDP)	**-2.4**	**-1.9**	**-2.1**	**-2.2**
HICP (avg. %YoY)	**1.3**	**1.2**	**1.3**	**1.5**

- Disappointing data points to a slight economic contraction in 2H18
- Private consumption is likely to remain very subdued supported by lower inflation, while labour market reflects some signs of deterioration
- Increasing higher political uncertainty and financial stress are weighing on investment
- Fiscal reforms could support domestic demand in the short-run, but fail to tackle the weakness of the domestic factors

Source: BBVA Research

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