BBVA Research

Eurozone Economic Watch

April 2019

Creando Oportunidades

Eurozone | More protracted activity weakness to cause lower growth in 2019, some recovery in 2020

- Weak growth persists in early 2019 as global headwinds (trade tensions, slowdown in main trading partners) and more protracted one-off factors (regulatory changes in autos, protests in France) have weighed on export orders and the industrial sector.
- Marked deterioration in confidence extended to March, especially in the manufacturing sector, which increased concerns on potential negative effects of higher uncertainty on domestic demand. But hard data for Q1 up to February was better than expected. Retail sales and industrial production rebounded, while exports increased. All in all, we remain cautious due to still gloomier leading indicators.
- GDP growth is expected to decelerate from 1.8% in 2018 to 1% in 2019, but should gain some traction in 2020 to 1.3%. The strength of domestic factors along with accommodative monetary policy should continue to underpin consumption and investment, while fiscal policy is slightly more expansive.
- Core inflation is still moderate (1%), while the headline rate will slow in coming months driven by energy prices. Tightening labour markets and slight wage pressures might gradually push up of core inflation.
- The ECB strengthened its forward guidance on rates (no hikes at least through the end of 2019) and launched a new series of seven quarterly TLTROs with 2-year maturity from Sep19 to support banks funding. We now expect the first depo rake hike (+10bps) in June 2020 and first refi rate hike (+25bps) in December 2020 (six months later than previously expected). Overall, the tone of the ECB has become more dovish recently.
- The most immediate risk remains Brexit, as the political deadlock in UK continues and a no-deal exit could not be ruled out. Political uncertainty remains high in several countries and at a broad European level. Other risks include higher tariffs on autos, a US recession and a hard landing in China.

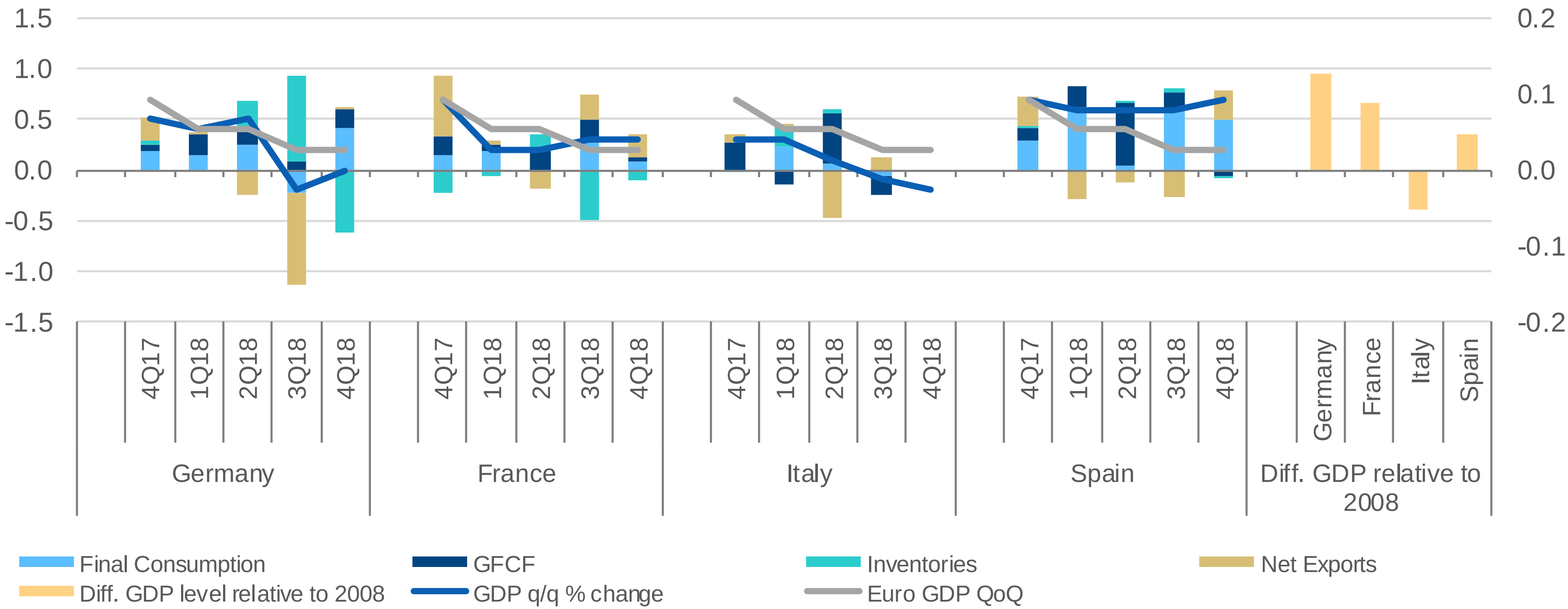
01

Economic developments

Italy slipped into recession in 4Q18 while Germany growth was flat, France's activity improved and Spain's expansion held steady

Week momentum seems to take root in the Eurozone by year end. Private spending remains resilient, but destocking weighed on growth, while exports recovered in 4Q18

GDP and expenditure contribution by country
(%QoQ, pp)



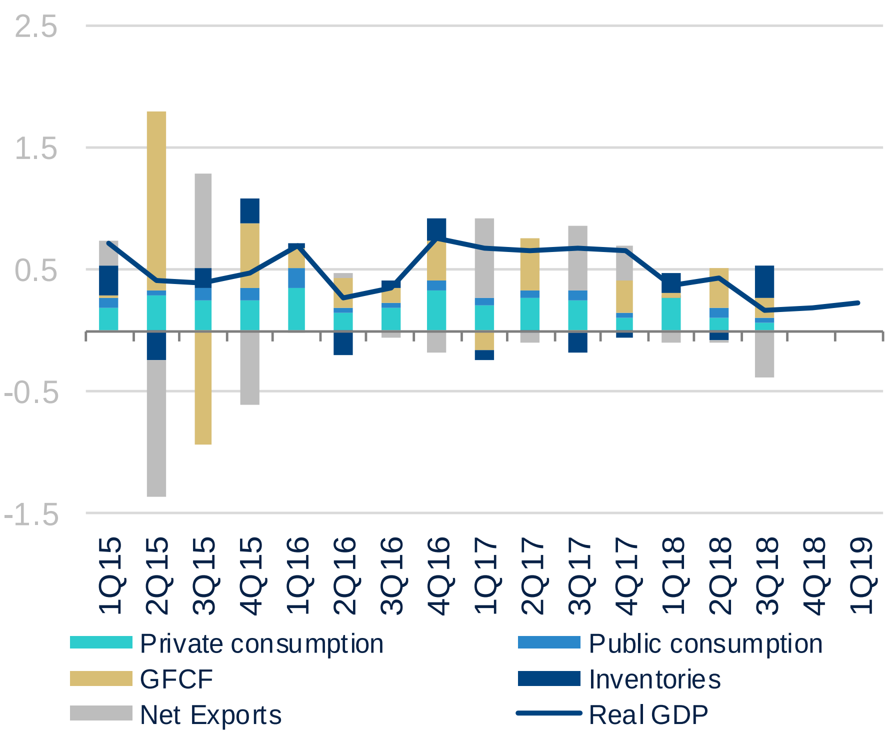
Source: Eurostat and BBVA Research

The weak momentum persists in early 2019, as global headwinds and more protracted one-off effects weigh on export orders and the industrial sector

Global headwinds have mainly affected the industrial sector through exports. However, still strong domestic demand and the deterioration of confidence seems to have halted for services and consumers.

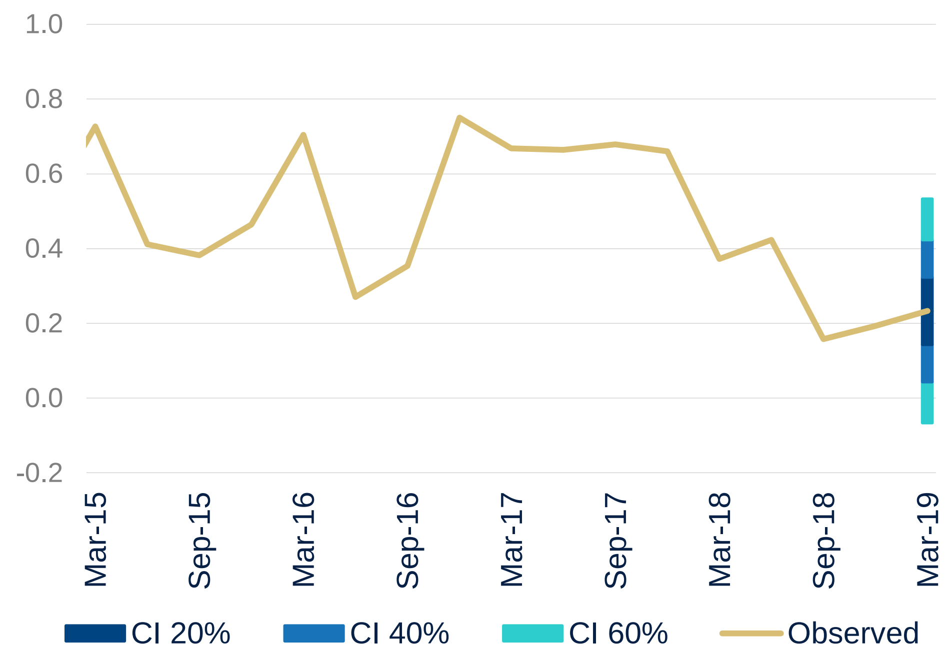
GDP, contribution by components

(%, QoQ)



GDP and MICA forecasts

(%, QoQ)



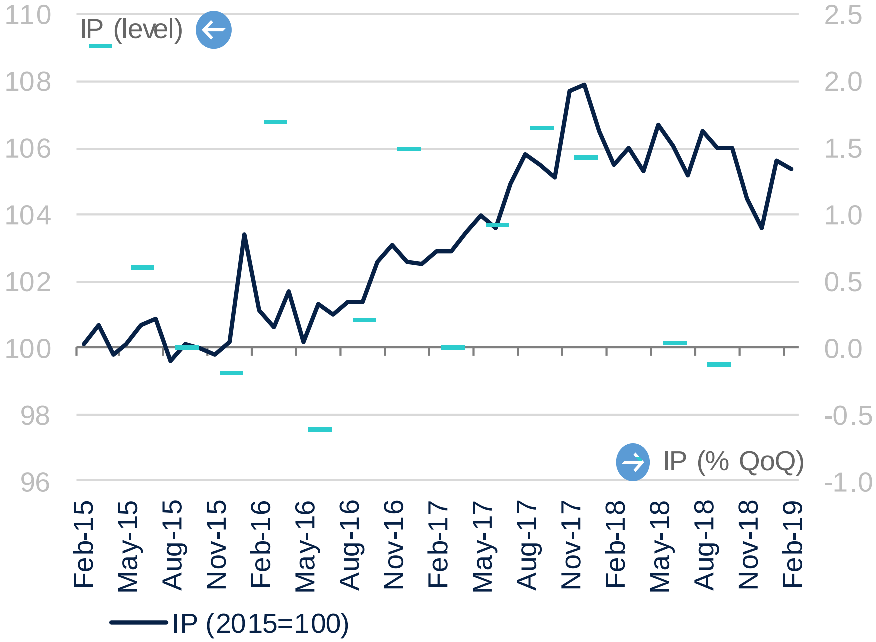
Source: Eurostat and BBVA Research

Industrial production in Q1 up to February has rebounded across sectors

Industrial production declined, dragged by energy and to a lesser extend capital and consumer durable goods. However, thanks to good January data industrial production has risen by 0.8% so far in Q1.

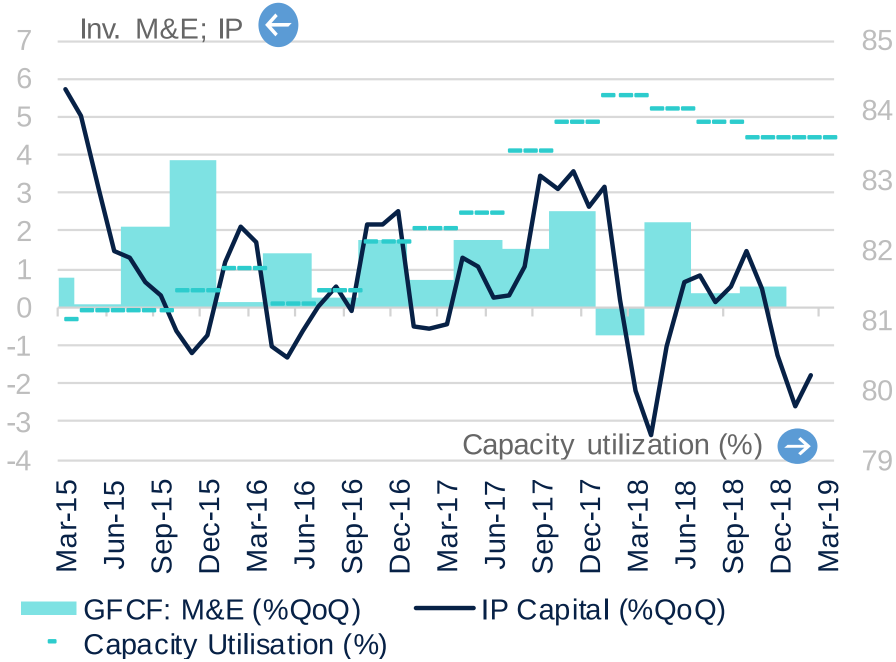
Industrial production

(Level, % QoQ)



IP capital equipment, investment in M&E and capacity utilization

(%QoQ; %)



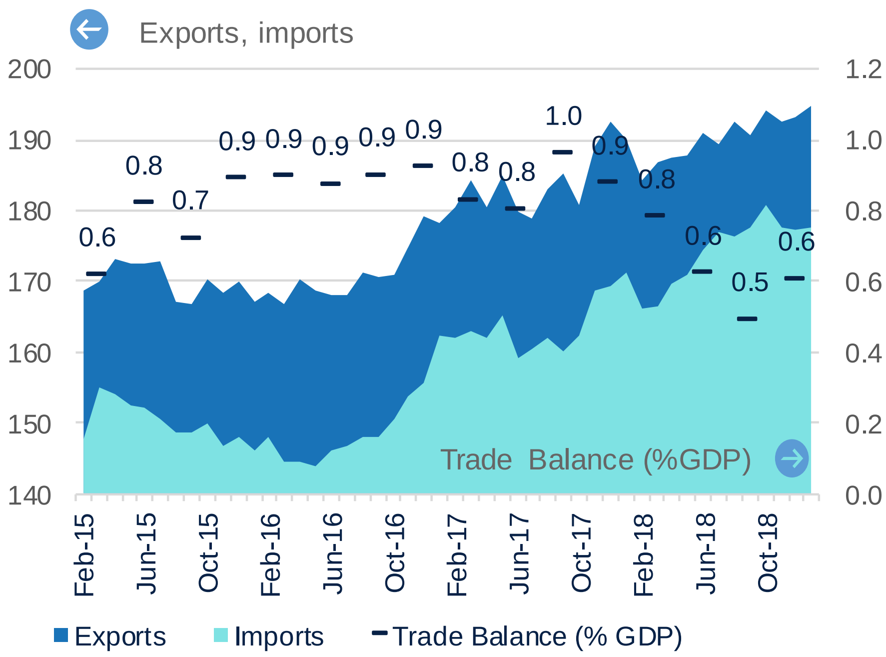
Source: Eurostat and BBVA Research

Exports increased in January for a second consecutive month, and have maintained a steady pace of around 1% QoQ over the last year

The Eurozone trade surplus is at its highest level since the change of emissions standards in the automotive sector

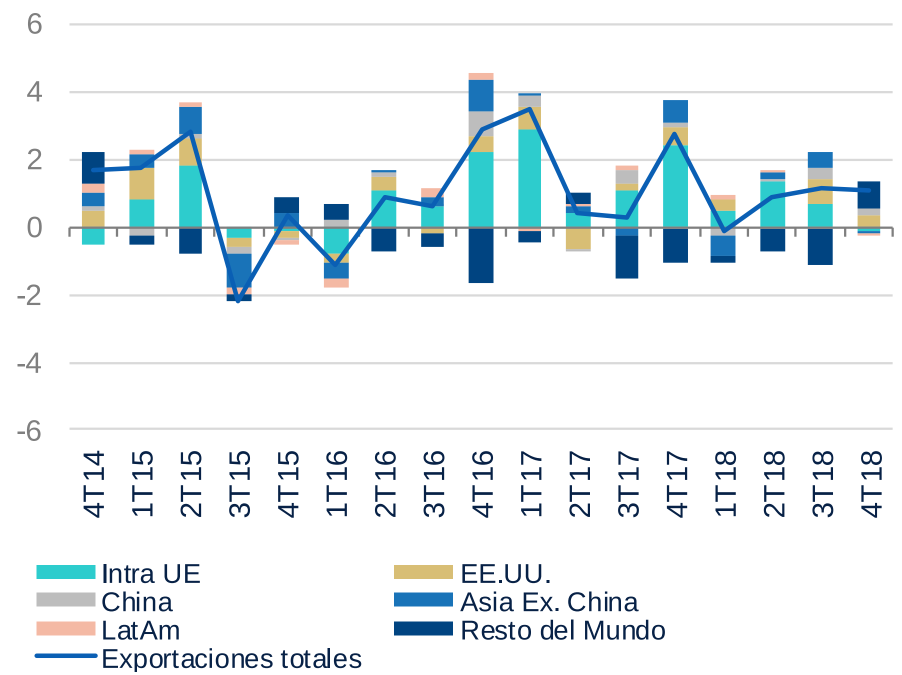
Trade balance

(€bn; %GDP)



Exports by destination

(%YoY; pp)



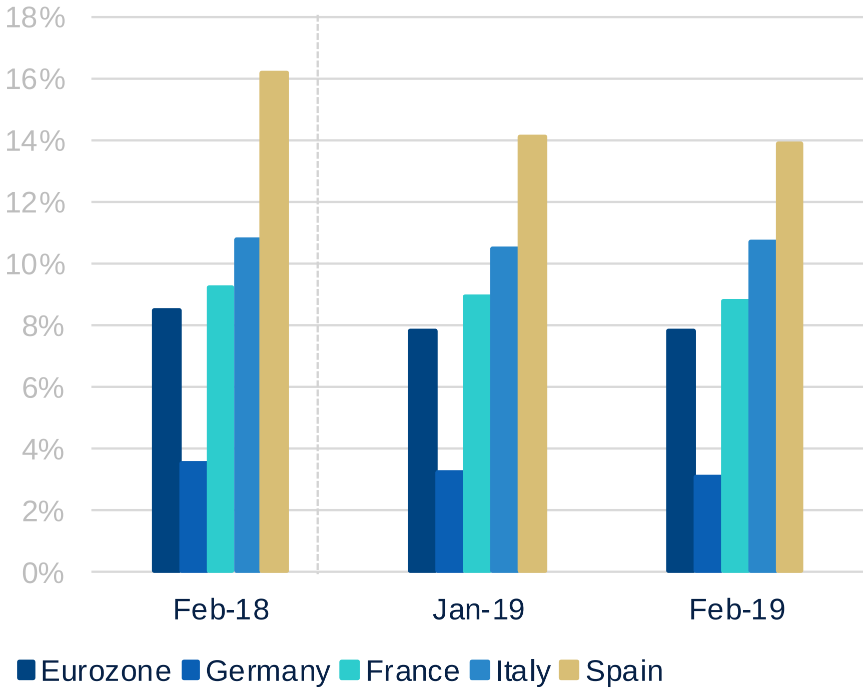
Source: Eurostat and BBVA Research

The unemployment in the Eurozone was broadly stable in February

In the labour market, the unemployment rate fell slightly in Germany, France and Spain. However it increased in Italy.

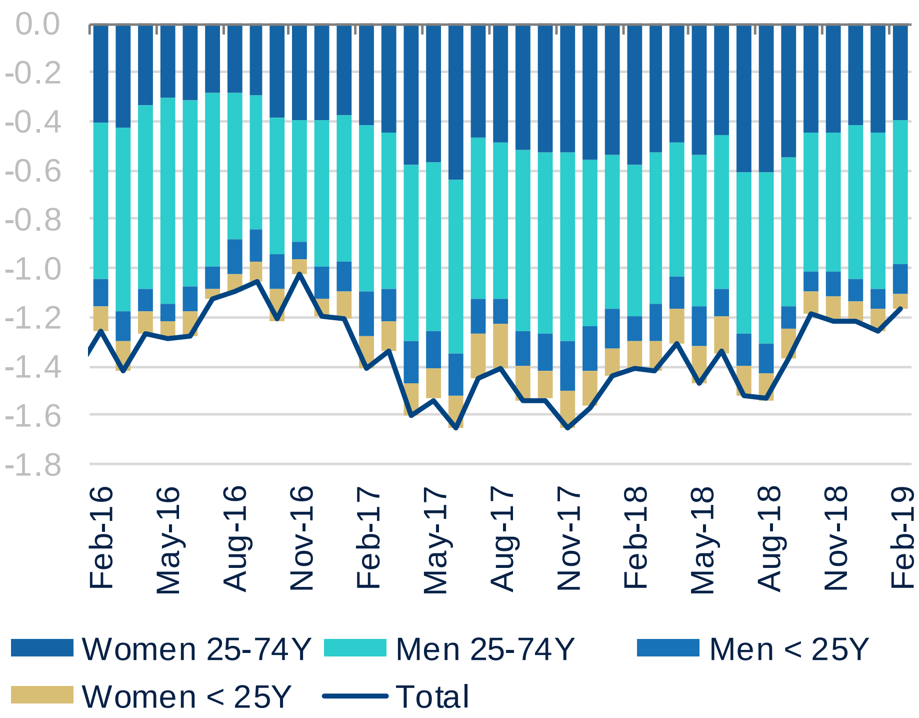
Unemployment rate by country

(%)



Annual unemployment change by gender and age

(Million)



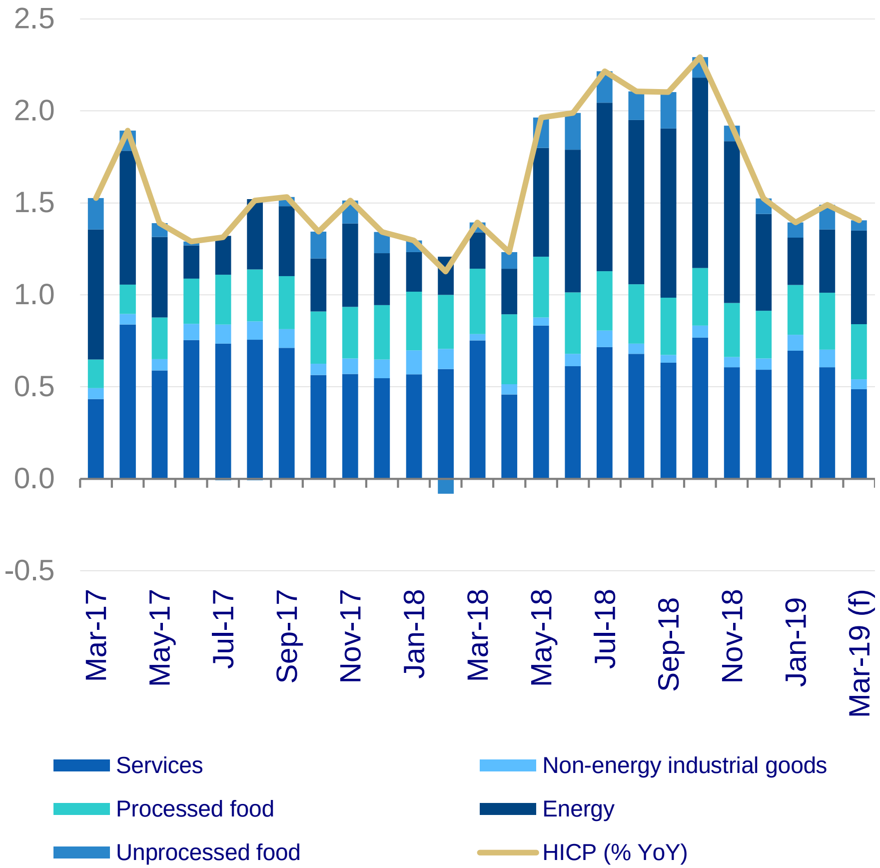
Source: Eurostat and BBVA Research

The lower rate of core inflation in March was due to calendar effects, especially visible in services

Brent oil prices will tilt inflation down in coming months to levels clearly below the ECB target, while core inflation is likely to increase very gradually

Inflation contribution of components

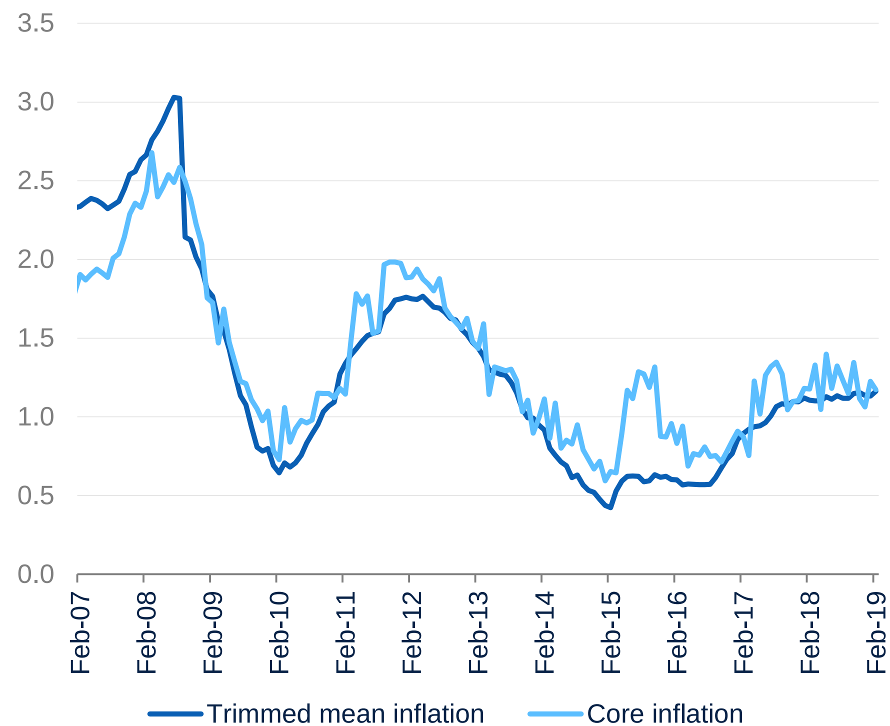
(%YoY, pp)



Source: Eurostat and BBVA Research

Core and trimmed-mean inflation

(%YoY; pp)

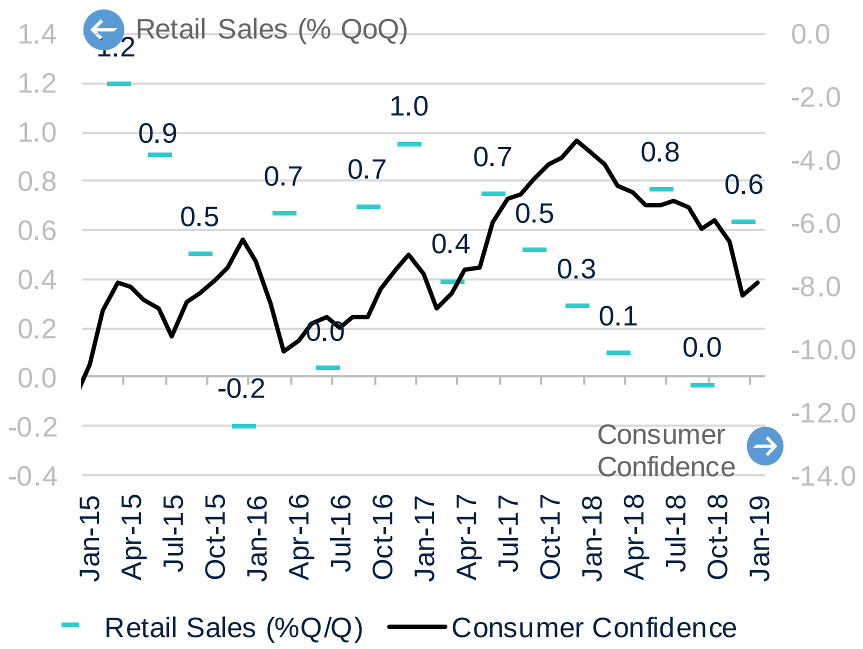


Retail sales increased in February for the second consecutive month, growing at a steady 0.5% in 1Q19 so far

In addition, the improvement in consumer confidence and labour market suggest private consumption will remain resilient in coming months

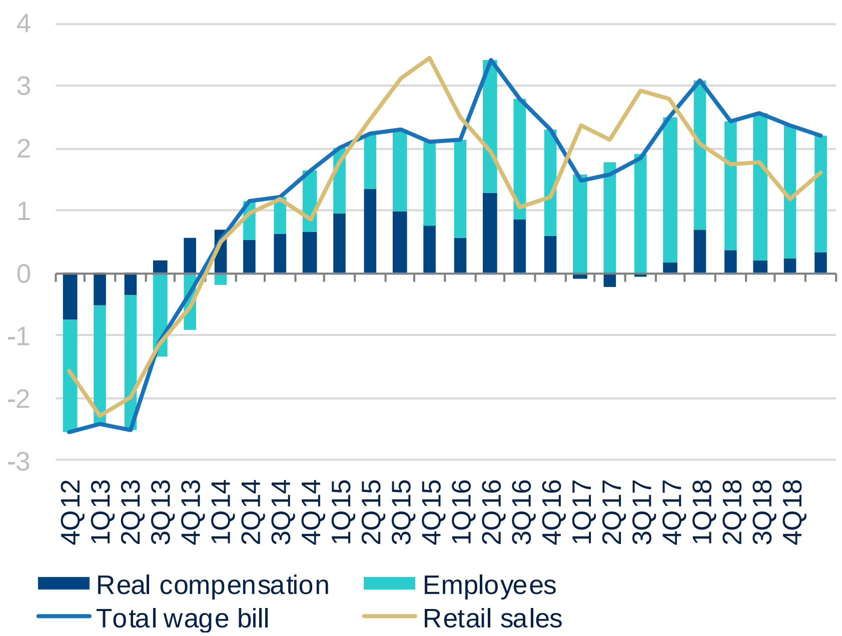
Retail sales and consumer confidence

(%QoQ, level)



Retail sales and total wage bill

(%YoY; pp)



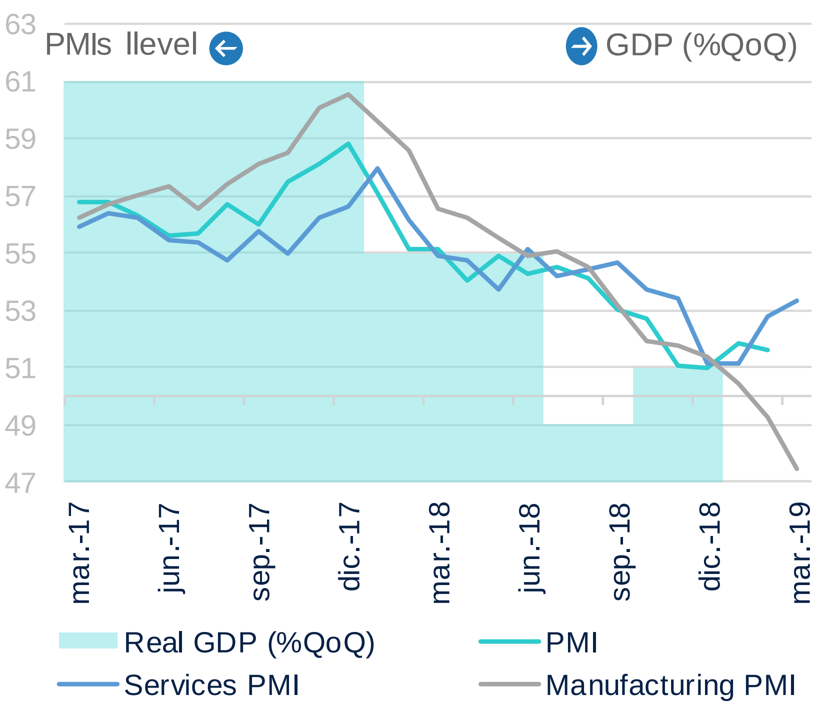
Source: Eurostat and BBVA Research

Worsening manufacturing confidence extended to March, in contrast with service sentiment, which went up swiftly

The gap between weak manufacturing and resilient services is widening. The increasing concern is about potential negative effects of higher uncertainty on domestic demand.

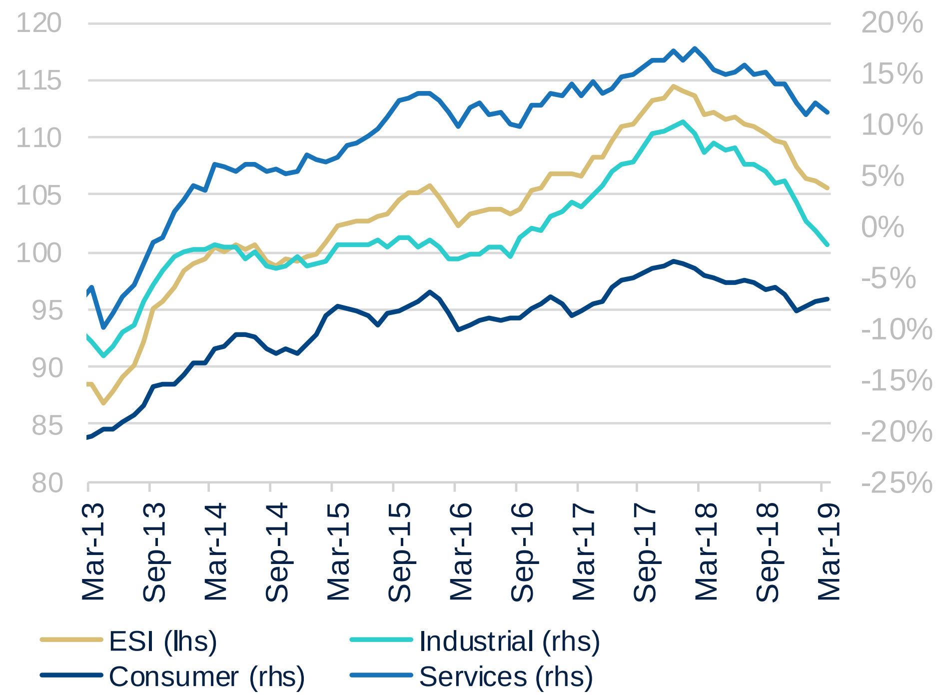
PMI and GDP

(level, %QoQ)



EC confidence survey

(level)

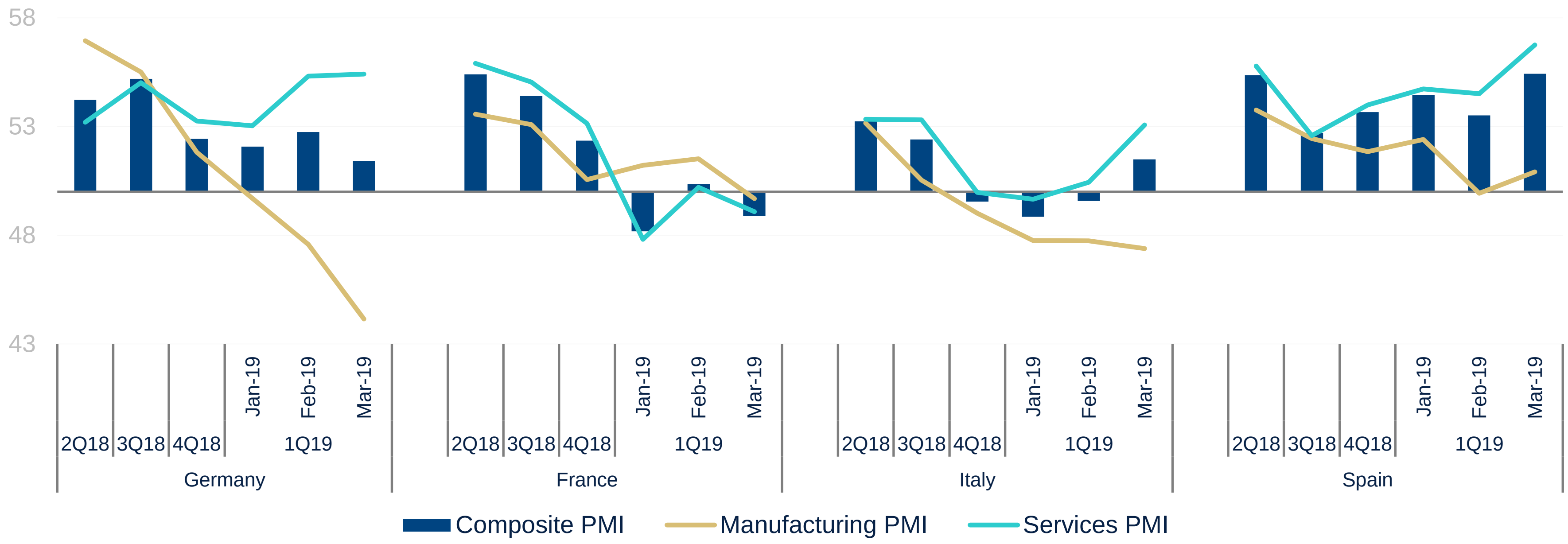


Source: Eurostat and BBVA Research

The worsening of industrial confidence is greater in those countries most exposed to the external sector

France reached contractive levels in both manufacturing and services in March, while in Germany and Italy the divergence them continues to increase. In Spain both sectors improved in March.

PMI Survey
(level)



Source: Markit and BBVA Research

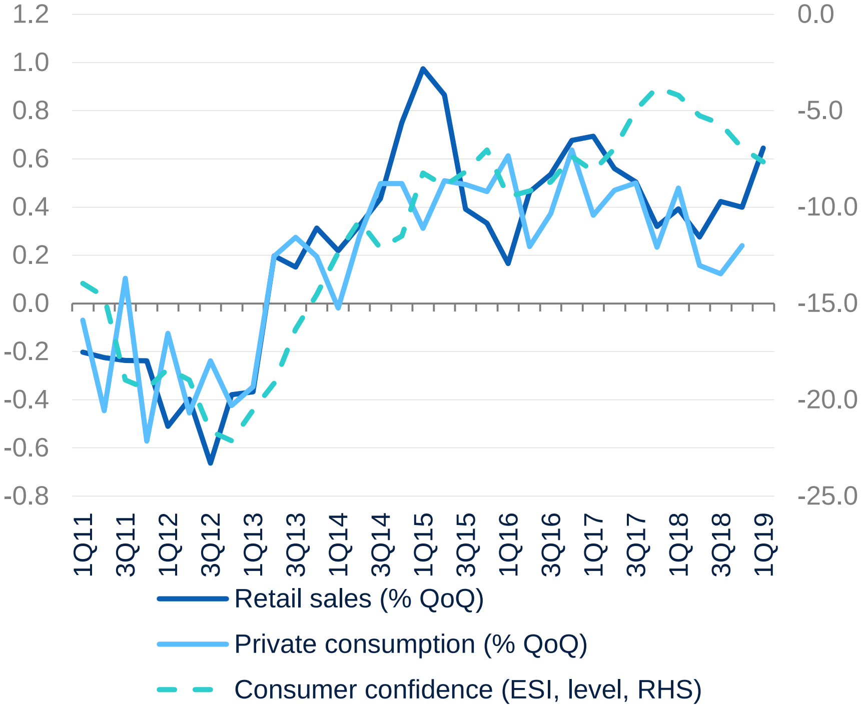
02

Updated forecasts

Strong domestic drivers and lower inflation support private consumption, but the mood is somewhat gloomier

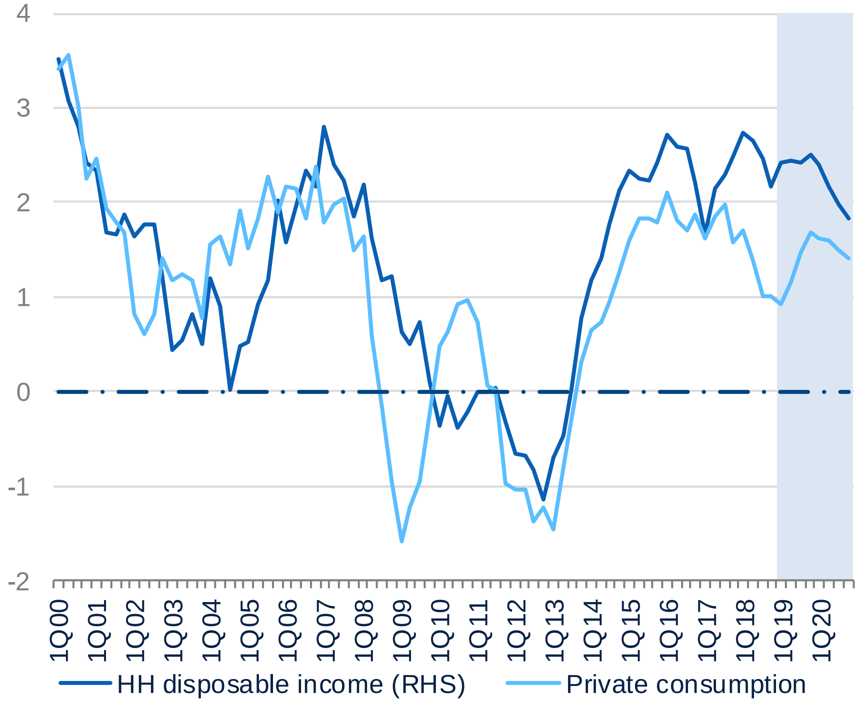
Eurozone: Private consumption, retail sales and ESI consumer confidence

(% QoQ; Level)



Eurozone: Private consumption and real labour income

(% YoYl)

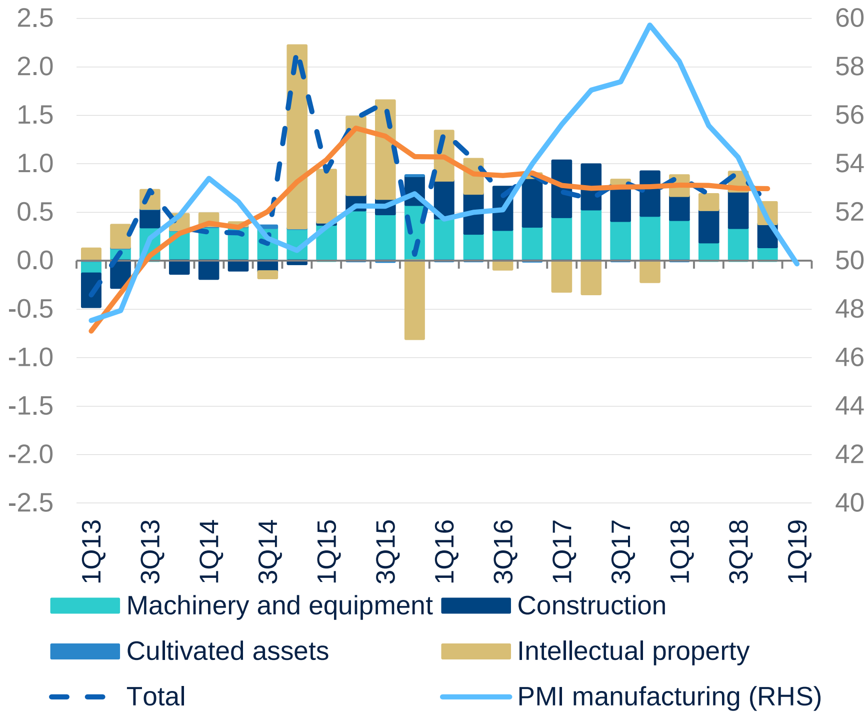


Source: BBVA Research

Steady investment growth, but higher uncertainty and lower profits could end up weighing on firms’ decisions

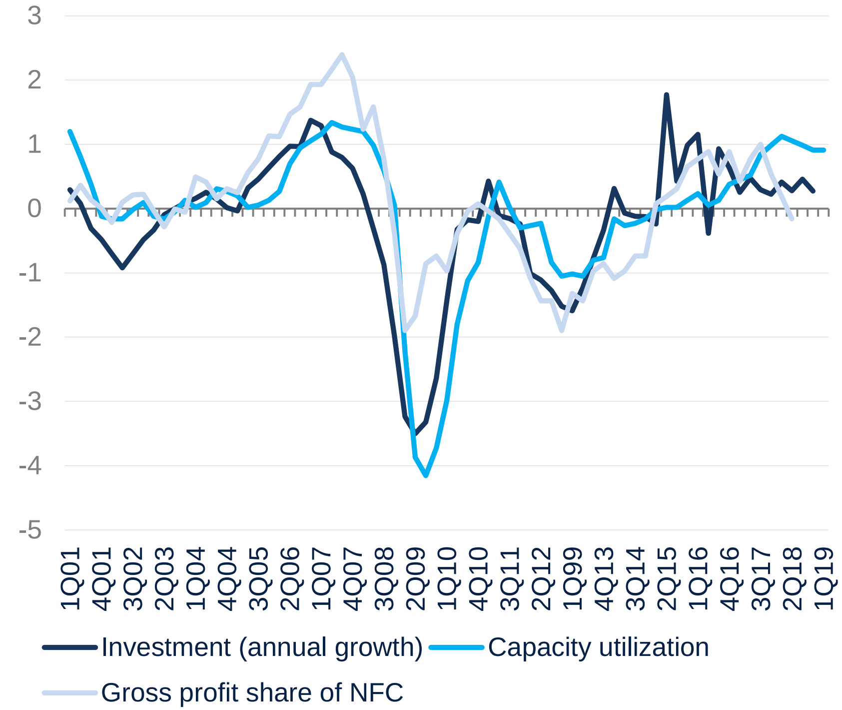
Eurozone: Investment and confidence

(% smooth QoQ, level)



Eurozone: Investment, capacity utilization and profit share

(%, pp)

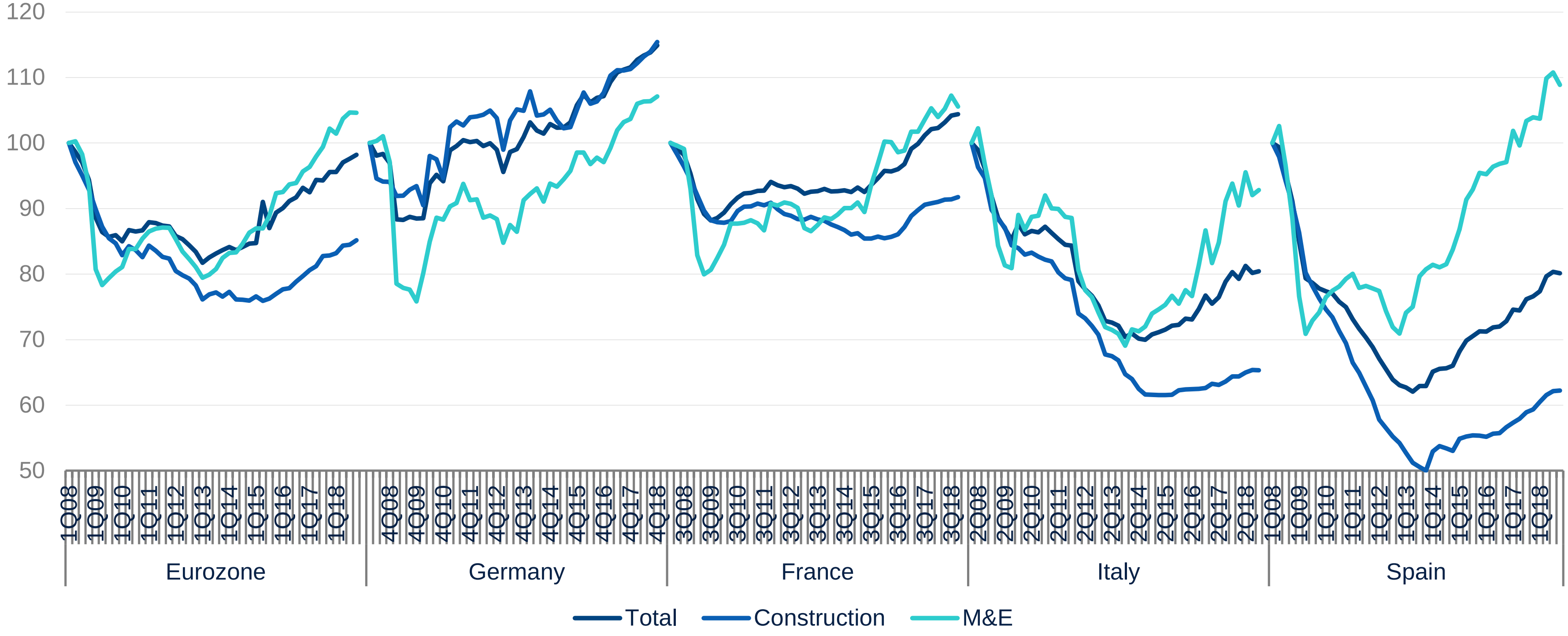


Source: BBVA Research

Early signs of more moderate investment growth ahead

Eurozone: Investment by country

(Index 1Q18=100)

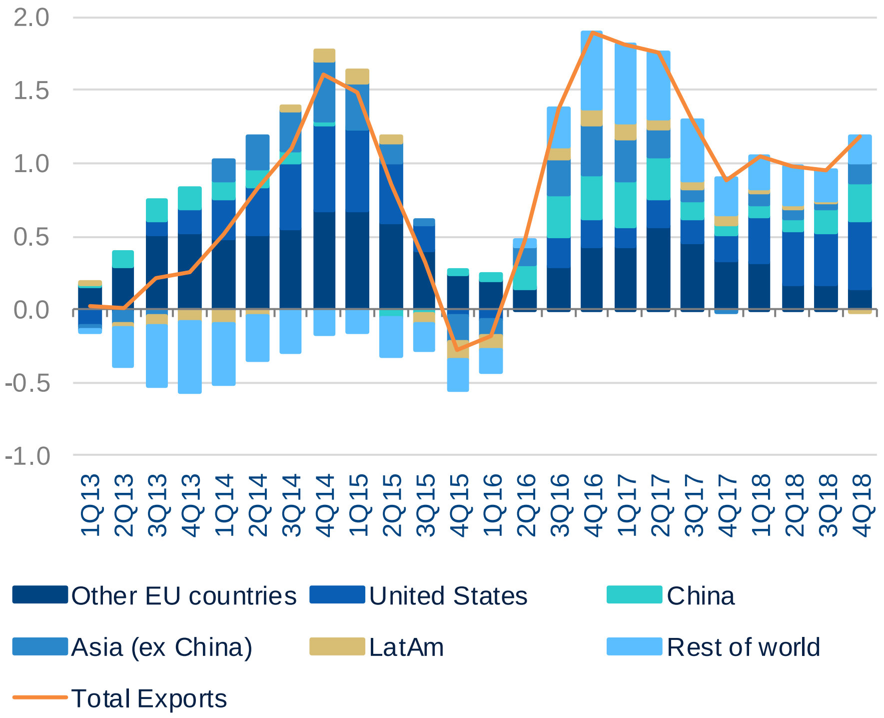


Source: BBVA Research

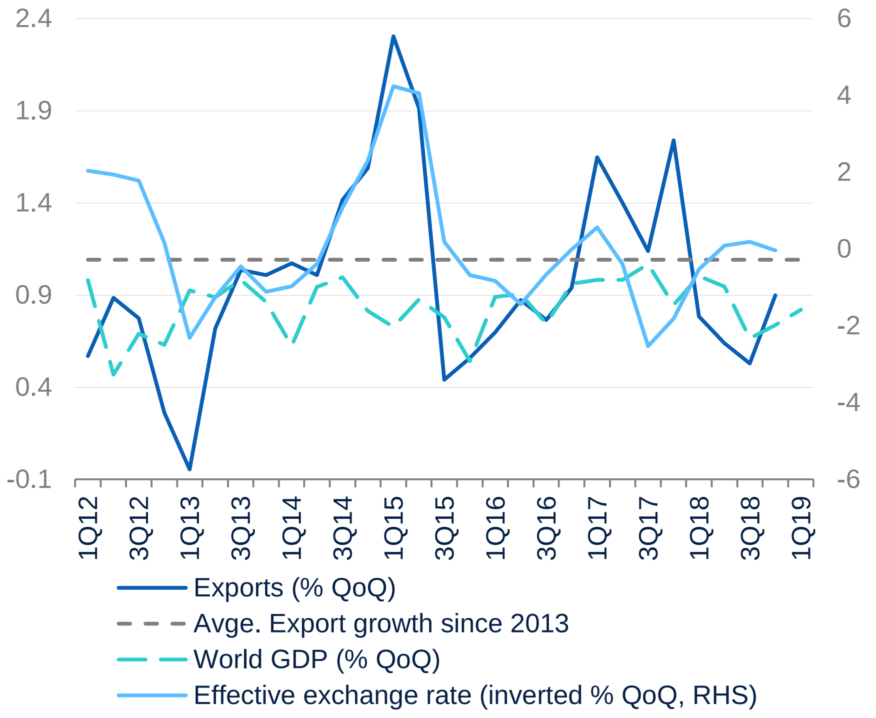
Exports remain resilient, growing at a slower pace in a context of a mild global slowdown but supported by a weaker euro

Eurozone: Exports by destination

(trade balance, % smoothed QoQ)



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



Source: BBVA Research

ECB's increased caution: lower rates for longer and more liquidity

Balance Sheet

- **End of QE** (December 2018)
- **Total QE reinvestment** after the beginning of interest rate's hiking cycle
- **New round of liquidity auctions (TLTRO III)** from September 2019 to March 2021, with a two-year maturity:
  - To avoid an abrupt adjustment of the financing of the banking sector
  - Less generous conditions than in previous rounds

Interest Rates

- **Low interest rate expectations reinforced** due to the economy's poorer performance and higher risks
- **No rate hikes expected until December 2020**

Source: BBVA Research

Eurozone: More prolonged activity weakness to cause lower growth in 2019; some recovery expected in 2020

Main macroeconomic indicators
(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**2.5**	**1.8**	**1.0**	**1.3**
Private consumption	1.8	1.3	1.3	1.5
Public consumption	1.2	1.0	1.4	1.2
Investment	2.9	3.1	2.2	2.3
Domestic Dem. (cont. pp)	**1.7**	**1.6**	**1.4**	**1.5**
Exports	5.5	3.0	2.1	2.6
Imports	4.1	2.9	3.1	3.5
Net Exports (cont. pp)	**0.8**	**0.2**	**-0.4**	**-0.3**
Current account (% GDP)	**3.2**	**2.9**	**2.5**	**2.4**
Budget balance (% GDP)	**-1.0**	**-0.6**	**-1.0**	**-1.0**
HICP (avg. %YoY)	**1.5**	**1.8**	**1.3**	**1.5**

Source: BBVA Research

- GDP forecasts revised down from 1.4% to 1.0% in 2019 and from 1.4% to 1.3% in 2020
- Growth moderation is mainly centered on exports and investment, which reflect the external demand moderation and lingering uncertainties (especially on Brexit and trade conflicts)
- Headline inflation revised downwards in 2019, converging to 1% over 2H19 due energy base effects
- Private consumption is holding up relatively well, but the risk is that a gloomier activity outlook drive it down

The most immediate risk remains Brexit: flexible delay until Oct 31, but all scenarios on the table

Flexible delay until Oct'19

After May repeatedly failed to pass the withdrawal agreement before April 12, a **flexible delay until Oct 31 has been agreed** subject to UK holding EP elections and a compromise not to disrupt the EU decision-making process (to be revised in June).

An **earlier Brexit date** is contemplated **if the withdrawal agreement were passed** before October.

If UK fails to hold European elections, UK will have to leave the EU with no deal on June 1 (unless they have already voted the deal).

This flexible extension is an **intermediate solution** to overcome different positions between Germany and France. But it withdraws the incentives for either soft and hardliners to approve the deal in the short term (now hardliners are less afraid of a prolonged process leading to a no Brexit; and soft-liners do not feel the pressure to avoid a cliff edge in June).

All scenarios on the table

Brexit cliff-edge has been avoided on Friday 12, but little changes to help to break Brexit impasse.

The **most feasible outcome remains a cross-party agreement** through Labour-Conservative talks or indicative votes, **but it is hard to reach before May 22**.

Other options: i) a second confirmatory referendum (to confirm a majority agreement); ii) a general election (if no agreement). iii) a no-deal exit in October (or June, if they do not hold EP elections).

10 April		23-26 May		31 October
10 April Flexible extension	Cross-party talks / indicative votes. Eventual early Brexit	23-26 May European elections	Eventual second confirmatory referendum / General elections	31 October New deadline: Deal; no deal; extension

Germany: Downward revision due to a longer than expected effect of transitory effects and the impact of the global slowdown

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**2.5**	**1.5**	**0.8**	**1.4**
Private consumption	2.0	0.9	1.3	1.4
Public consumption	1.6	1.0	1.8	1.5
Investment	3.6	2.7	2.3	2.5
Domestic Dem. (cont. pp)	**2.1**	**1.8**	**1.4**	**1.5**
Exports	5.3	2.2	1.3	2.2
Imports	5.3	3.4	2.9	2.7
Net Exports (cont. pp)	**0.3**	**-0.4**	**-0.6**	**-0.1**
Current account (% GDP)	**8.0**	**7.4**	**6.7**	**6.4**
Budget balance (% GDP)	**1.0**	**1.6**	**1.1**	**0.8**
HICP (avg. %YoY)	**1.6**	**2.0**	**1.4**	**1.6**

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 that is taking longer than expected. However, the February data were mixed in the sector. Production increased as orders continued to fall.
- However, the fundamentals of the economy remain strong (domestic demand, wages, and jobs) and the government has fiscal room to take action if necessary.
- Strong doubts, reflected in confidence, can weaken investment. In addition, the slowdown in trade is having a special impact on an export-oriented economy such as Germany.

France: Slightly outperforming in the Eurozone thanks to robust domestic demand and less exposure to external demand

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**2.3**	**1.6**	**1.2**	**1.5**
Private consumption	1.2	0.9	1.1	1.3
Public consumption	1.4	1.1	1.4	1.3
Investment	4.7	2.9	2.5	2.4
Domestic Dem. (cont. pp)	**2.2**	**1.0**	**1.4**	**1.6**
Exports	4.7	3.3	1.8	2.2
Imports	4.1	1.3	2.3	2.3
Net Exports (cont. pp)	**0.1**	**0.6**	**-0.2**	**-0.1**
Current account (% GDP)	**-0.6**	**-0.3**	**-0.4**	**-0.5**
Budget balance (% GDP)	**-2.8**	**-2.5**	**-3.3**	**-2.3**
HICP (avg. %YoY)	**1.2**	**2.1**	**1.3**	**1.5**

- The fiscal stimulus helps to moderate the extent of the deceleration
- However, confidence in contractionary territory in both services and manufacturing signals the danger of a deceleration
- The French economy is less exposed that others in the EZ to the global slowdown.

Source: BBVA Research

Italy: From deceleration to recession after a combined effect of internal weakness and global weakness

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018 (e)	2019 (f)	2020 (f)
Real GDP	**1.7**	**0.8**	**-0.2**	**0.5**
Private consumption	-0.2	0.2	0.0	0.3
Public consumption	4.5	3.2	0.2	1.2
Investment	4.5	3.2	0.2	1.2
Domestic Dem. (cont. pp)	**1.4**	**0.9**	**0.1**	**0.5**
Exports	6.4	1.4	1.8	2.5
Imports	5.8	1.8	2.9	2.5
Net Exports (cont. pp)	**0.3**	**-0.1**	**-0.3**	**0.0**
Current account (% GDP)	**2.6**	**2.5**	**2.3**	**2.4**
Budget balance (% GDP)	**-2.4**	**-2.0**	**-2.5**	**-2.6**
HICP (avg. %YoY)	**1.3**	**1.2**	**0.9**	**1.2**

- The data available in Italy have shown a greater weakness than expected in early 2019
- Very weak domestic demand failed to take over from a slowing global demand
- Continued higher political uncertainty and financial stress are weighing on investment
- Lower growth puts more pressure on fiscal sustainability to meet fiscal targets

Source: BBVA Research

Eurozone Economic Watch

April 2019

Creando Oportunidades

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