BBVA Research

Eurozone Economic Watch

July 2019

Creating Opportunities

Eurozone | Growth projected at 1.2% this year and 1.3% next amid continued weakness in the industrial and external sector

- Hard data for 2Q19 so far were somewhat disappointing despite good performance in May. Exports failed to recover from previous falls and point to a bleak outlook after being resilient in previous quarters. This was reflected in the weakness of the industrial sector, although with some signs of stabilization driven by increasing output of consumer and capital goods. Retail sales remained solid favoured by labour market conditions and low inflation.
- Confidence surveys up to June were mixed with more stable manufacturing sentiment and the resilience of services expectations. Leading components do not suggest activity to gain clearly momentum in the short-term.
- Our MICA-BBVA model estimates GDP growth to have slowed to around 0.2% QoQ in 2Q19 (down from 0.4%) and is likely to remain broadly steady in 2H19.
- Core inflation increased by 0.3pp to 1.3% YoY in June driven by higher services prices, but is expected to remain at low levels and increase only gradually in coming months in a context of very low inflation expectations.
- The ECB strengthened its forward guidance on rates (no hikes at least until mid-2020), launched a new TLTRO and extended reinvestment of QE. We now expect a depo rake cut (-10bps) in 3Q19 along with a tiered deposit system.
- We have marginally modified our Eurozone GDP projections due to the persistence of industrial sector weakness and uncertainty (trade tensions and Brexit), but further easing monetary policy and slightly expansive fiscal policy should halt the worsening of confidence, underpin spending decisions and stem euro appreciation. As a result, GDP growth is expected to decelerate to 1.1% in 2019 (revised up by 0.1pp) and remain relatively stable in 2020 at 1.2% (revised down by 0.1pp). Across large countries, Germany should recover next year form a weak 0.8% in 2019, France could grow around potential, while Spain and Italy will grow well above and below the average, respectively.
- Risks are tilted to the downside: Higher probability of a hard Brexit after the new UK PM toughened his position to deliver Brexit on October 31 with or without a deal, and high political uncertainty (Italy, a more fragmented EU Parliament). External risks include increasing global protectionism, the US threat of higher tariffs to the auto sector, the risk of US recession and a hard landing in China.

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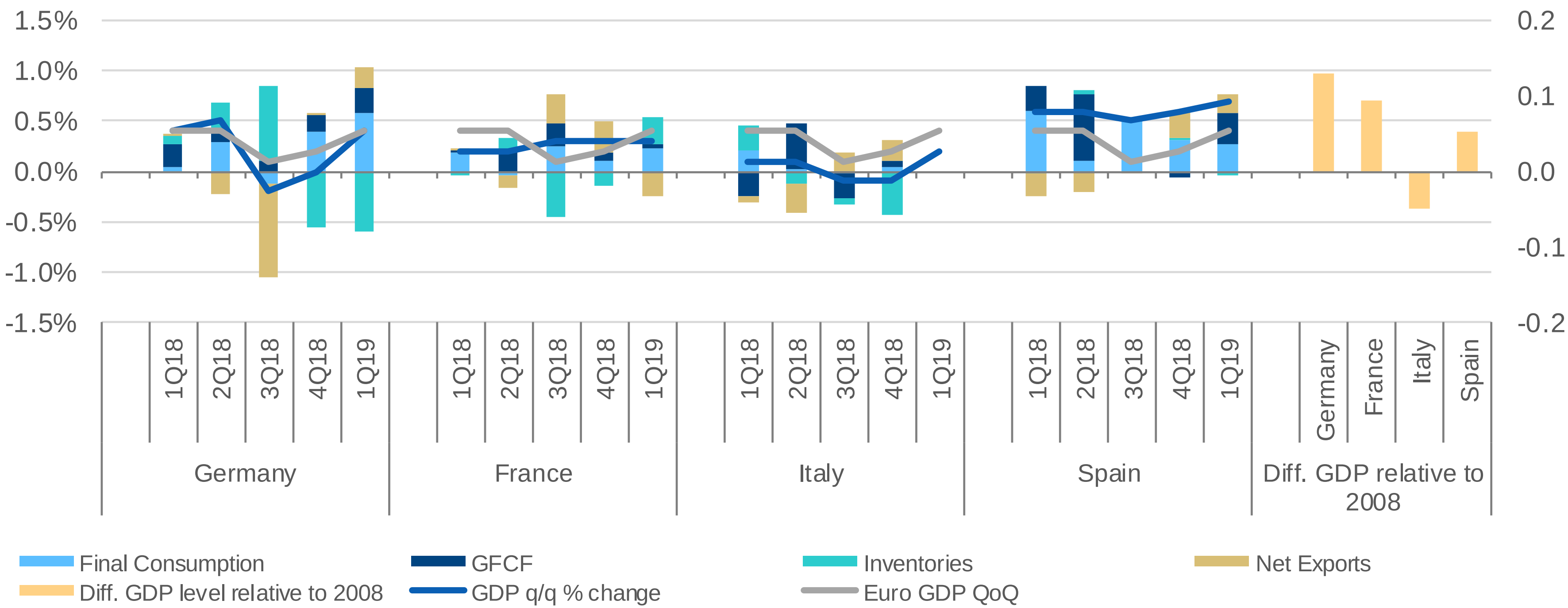
Recent developments

GDP growth gained momentum in 1Q19 across the region, supported by private consumption and investment…

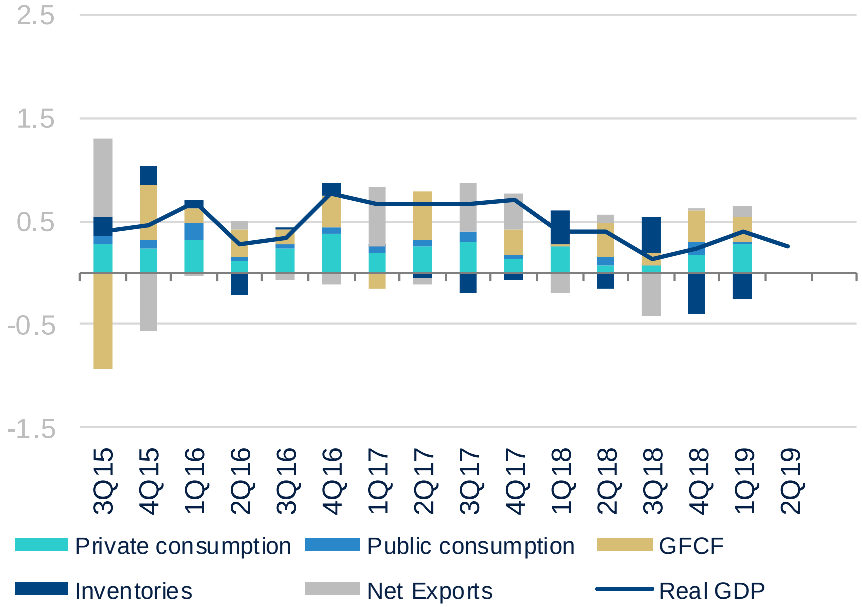
GDP and expenditure contribution by country
(%QoQ, pp)



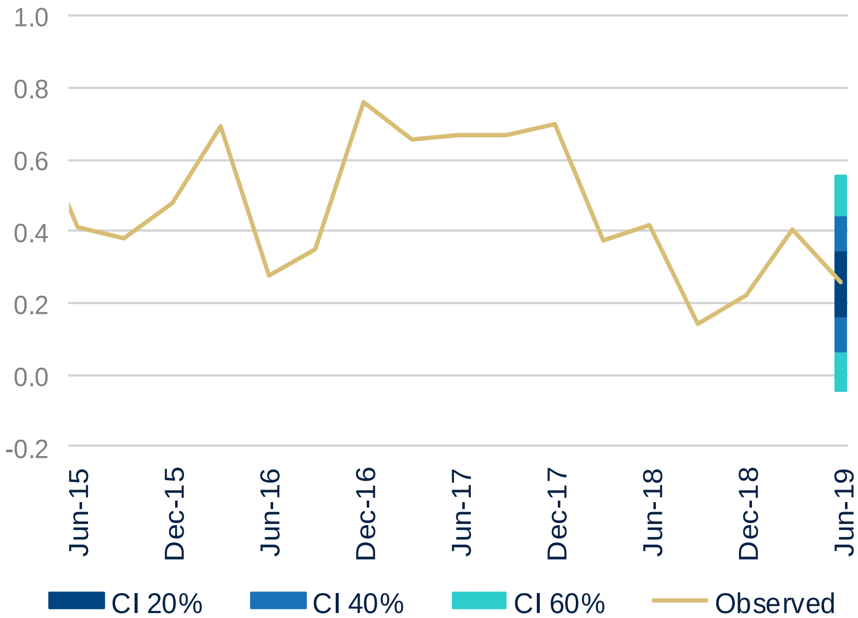
Source: Eurostat and BBVA Research

… but softer growth is taking root on the weakness of foreign and the industrial sector, despite still strong domestic demand

GDP, contribution by components
(%, QoQ)



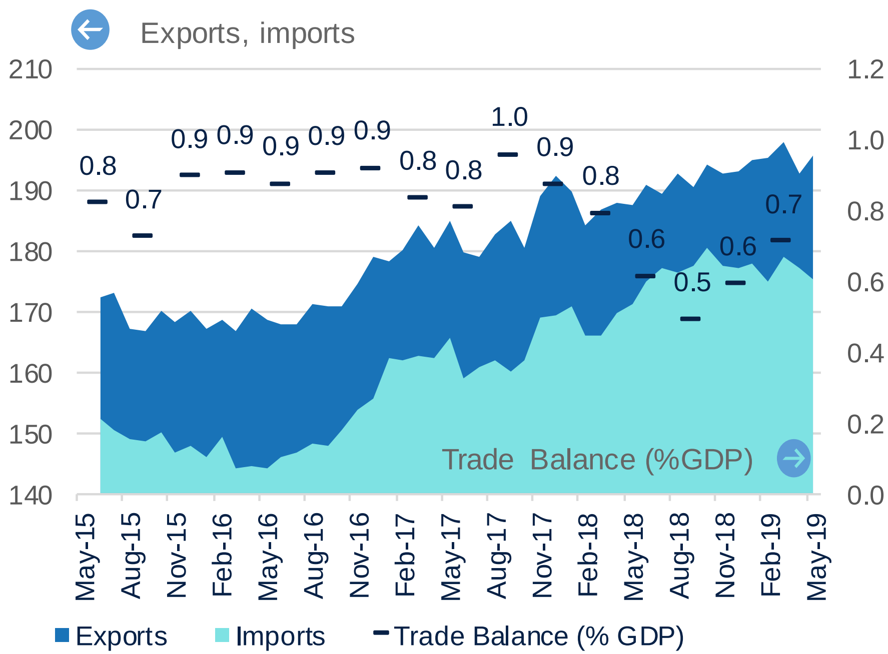
GDP and MICA forecasts
(%, QoQ)



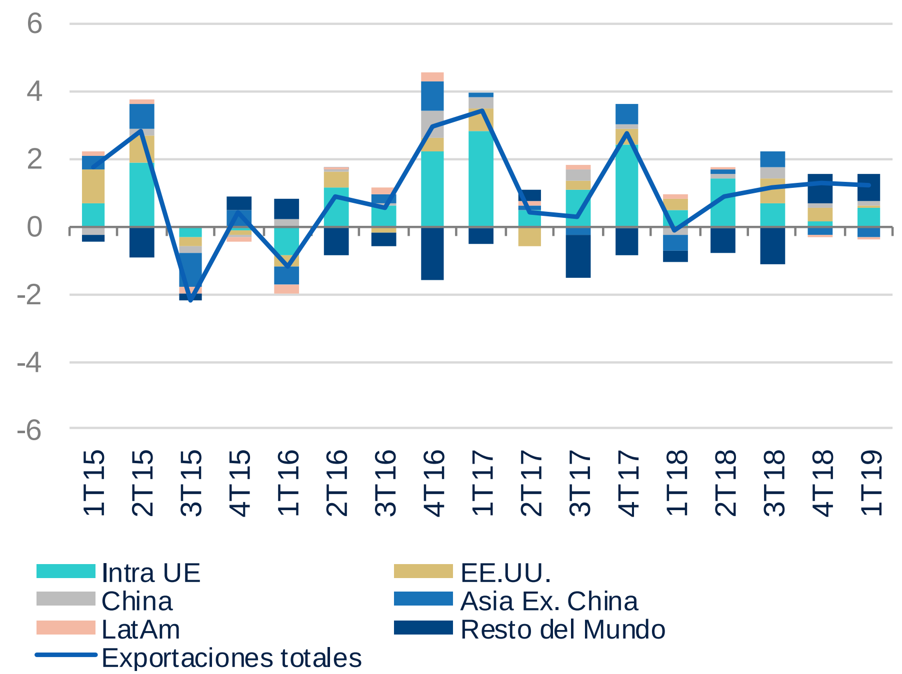
Source: Eurostat and BBVA Research

Exports grew in May but failed to recover from previous fall, suggesting a bleak outlook after being resilient in previous quarters

Trade balance
(€bn; %GDP)



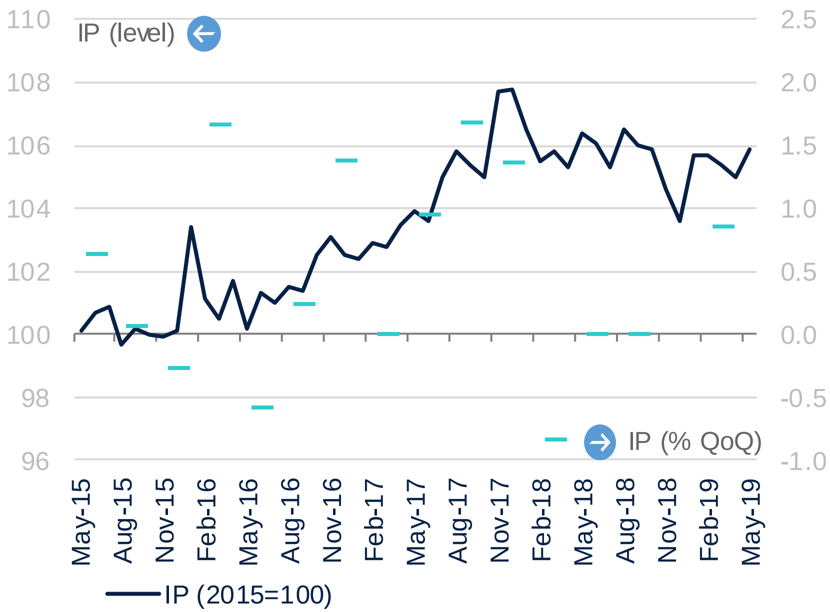
Exports by destination
(%YoY; pp)



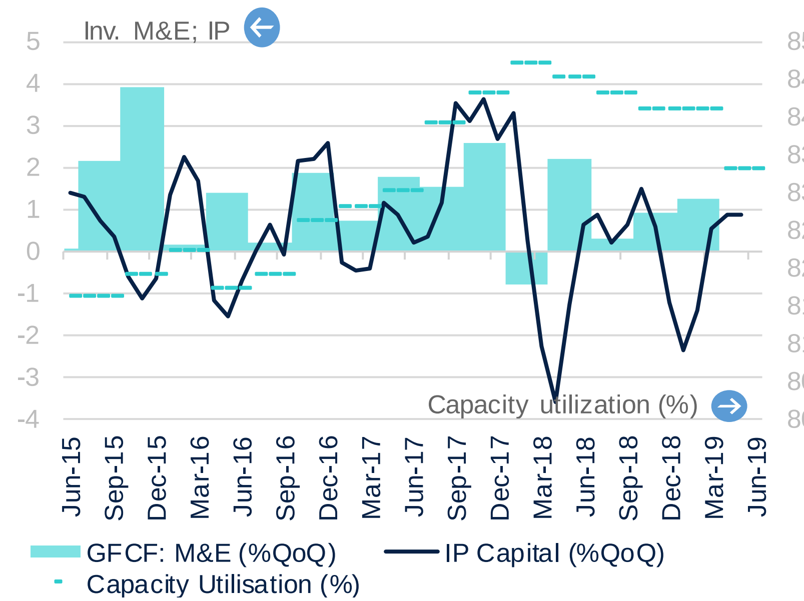
Source: Eurostat and BBVA Research

Signs of stabilization in the industrial sector in 2Q19 but still weak, supported by increasing consumer and capital goods output

Industrial production
(Level, % QoQ)



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

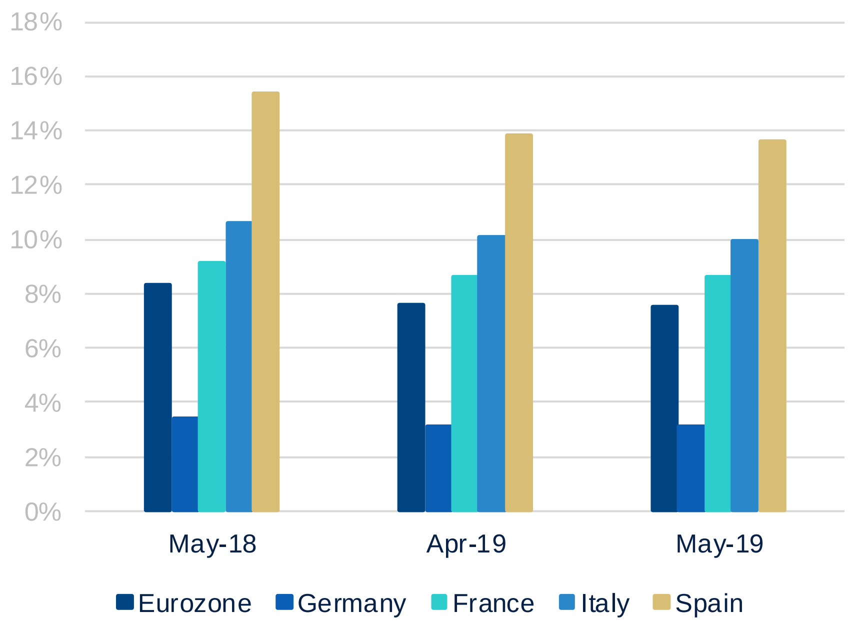


Source: Eurostat and BBVA Research

Steady job creation resulted in a lower unemployment rate about 0,7pp to 7.5% in May despite a softer momentum since mid-2018

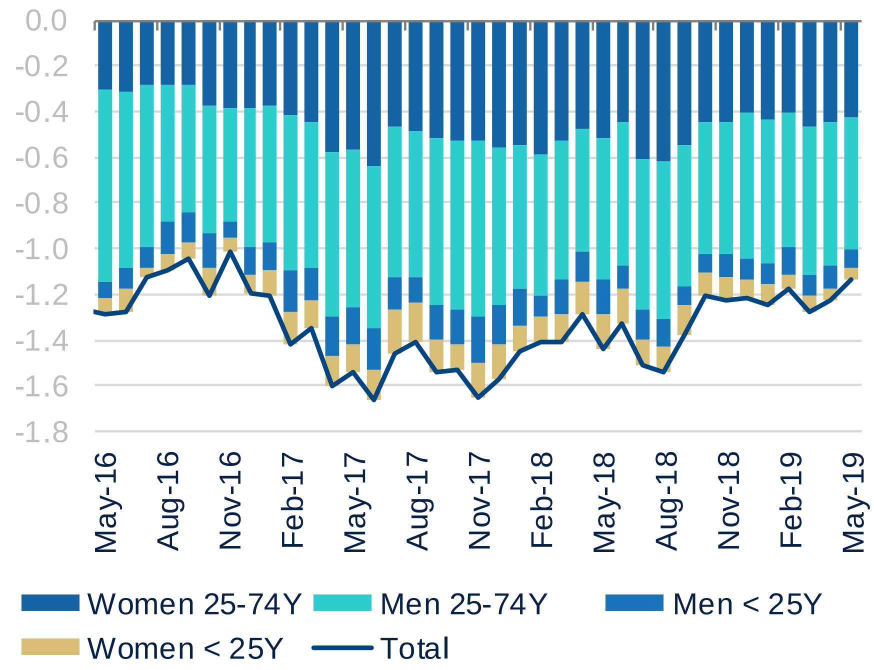
Unemployment rate by country

(%)



Annual unemployment change by gender and age

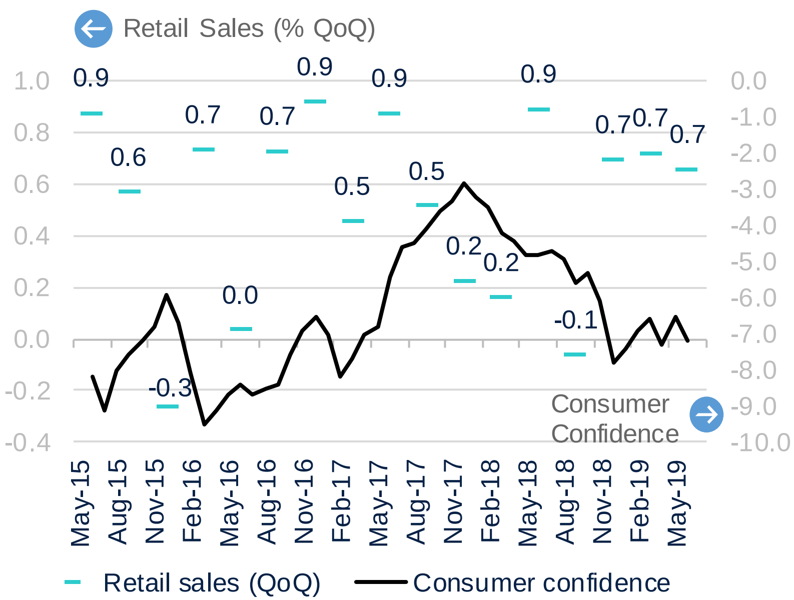
(Million)



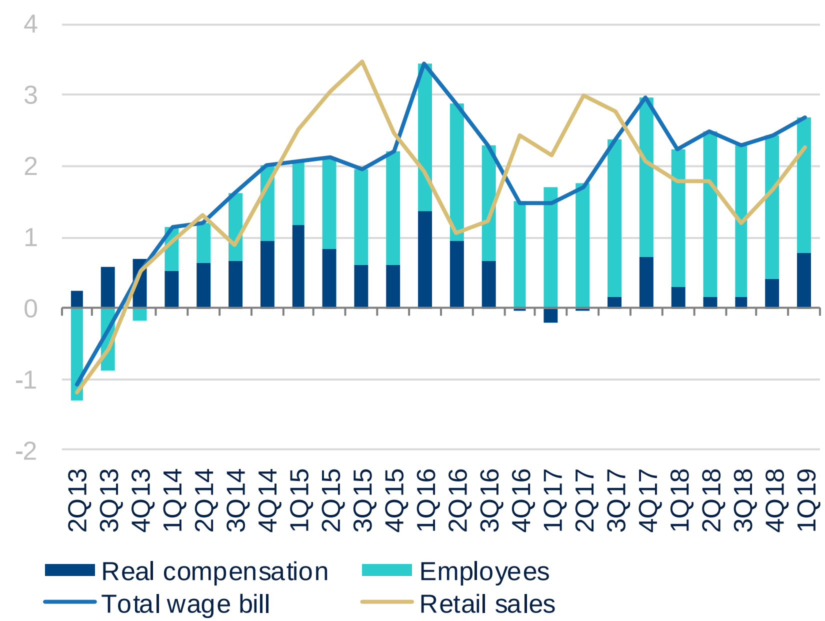
Source: Eurostat and BBVA Research

Solid retail sales up to May supported by labor market conditions and low inflation, but losing some steam due to gloomier mood

Retail sales and consumer confidence
(%QoQ, level)



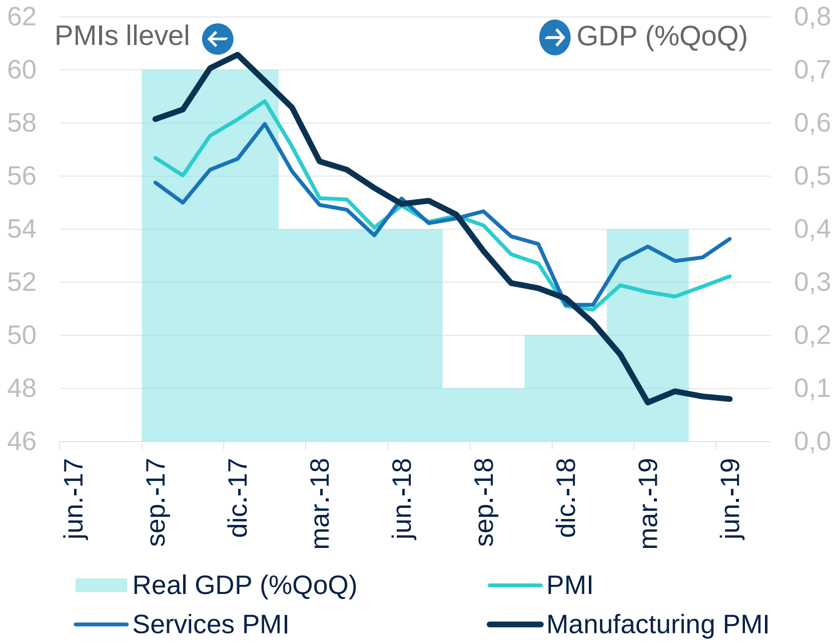
Retail sales and total wage bill
(%YoY; pp)



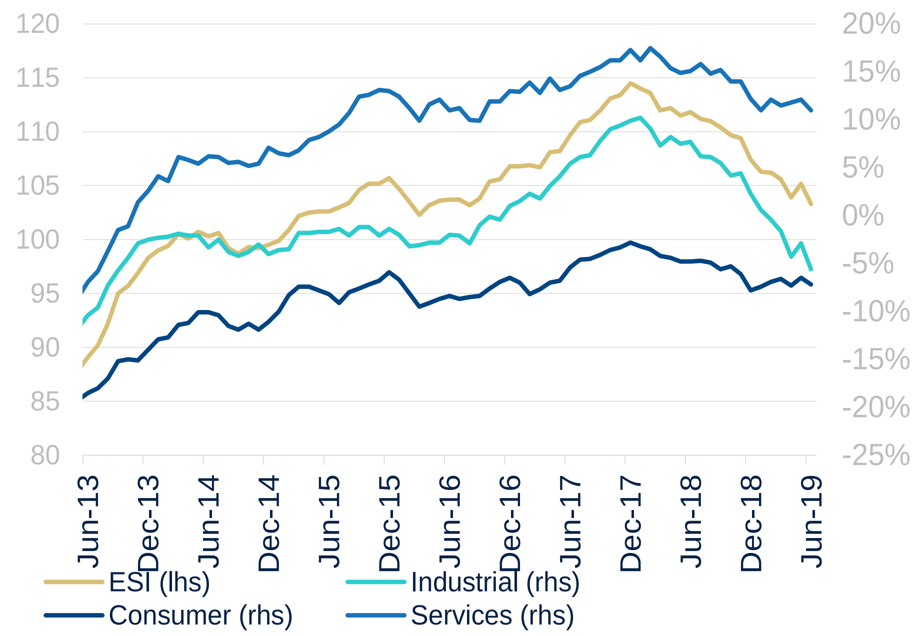
Source: Eurostat and BBVA Research

Mixed confidence up to June, signaling some stabilization in manufacturing and ongoing resilience of services

PMI and GDP
(level, %QoQ)



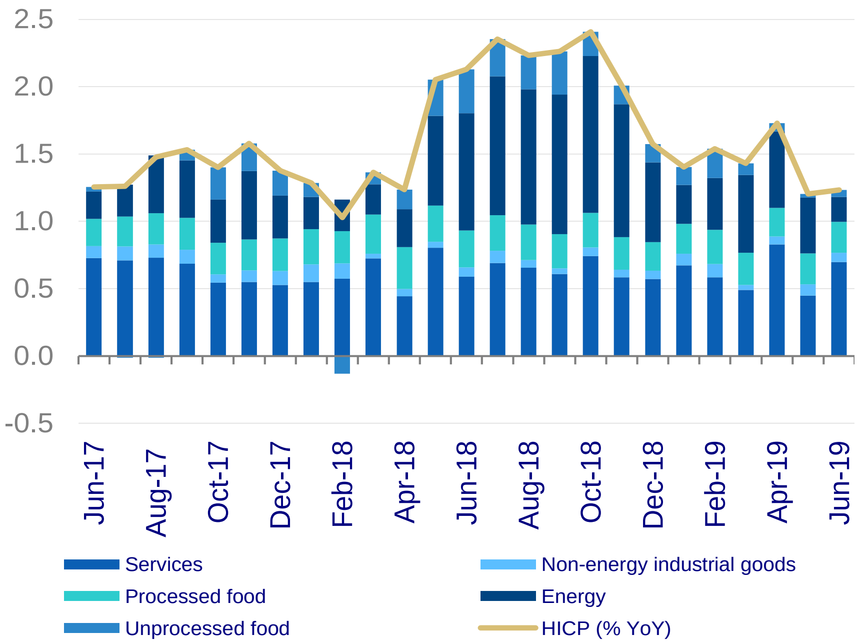
EC confidence survey
(level)



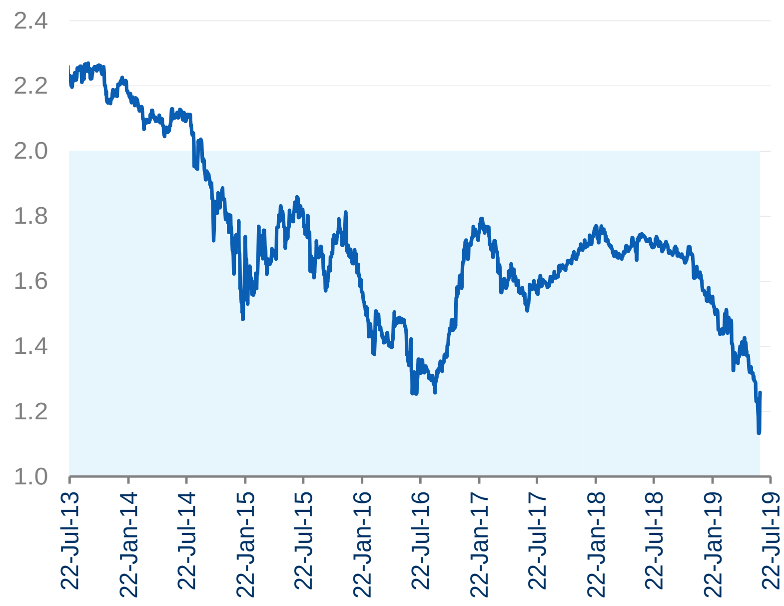
Source: Eurostat and BBVA Research

Core inflation increased to 1.3% YoY in June driven by higher services prices, though inflation is likely to remain low

Inflation contribution of components
(%YoY, pp)



Inflation swaps 5y5y
(%YoY)



Source: Eurostat, Bloomberg and BBVA Research

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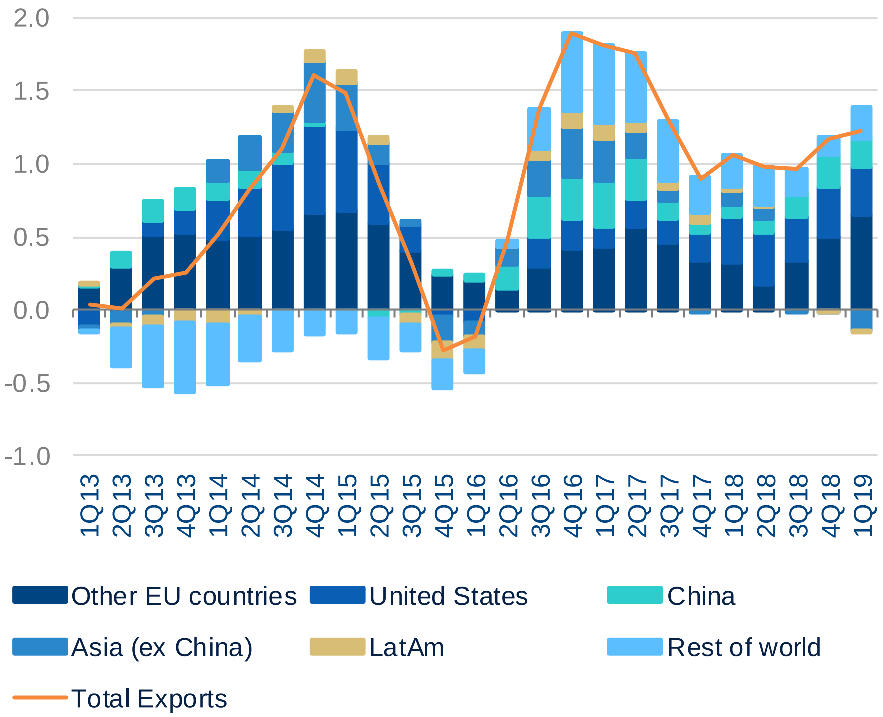
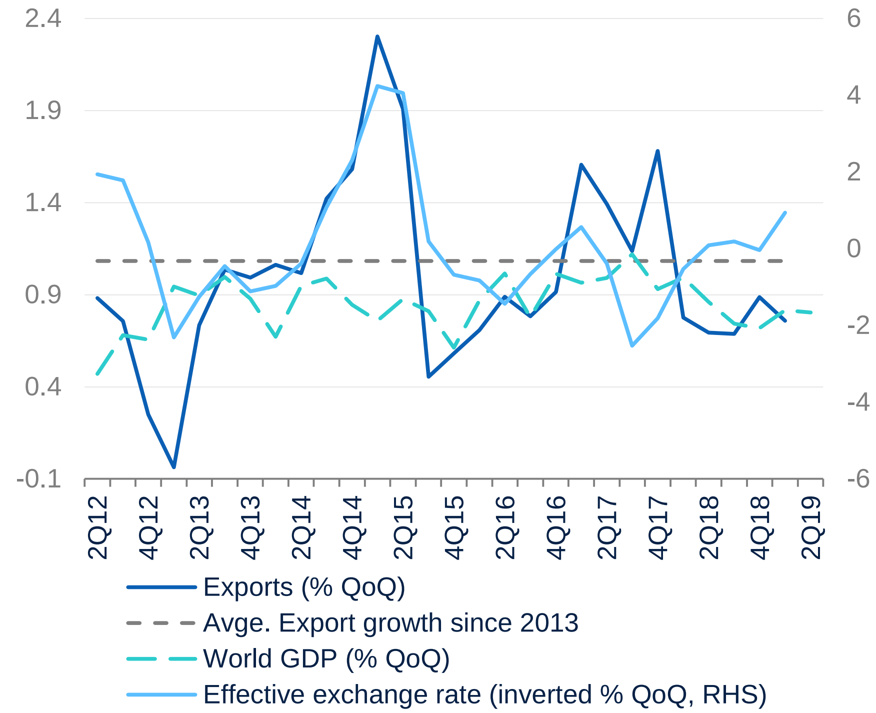
Updated forecasts

Exports: Recently they were supported by sales to other EU countries, but will be affected by the global slowdown and euro appreciation

Eurozone: Exports by destination (trade balance, % smoothed QoQ)



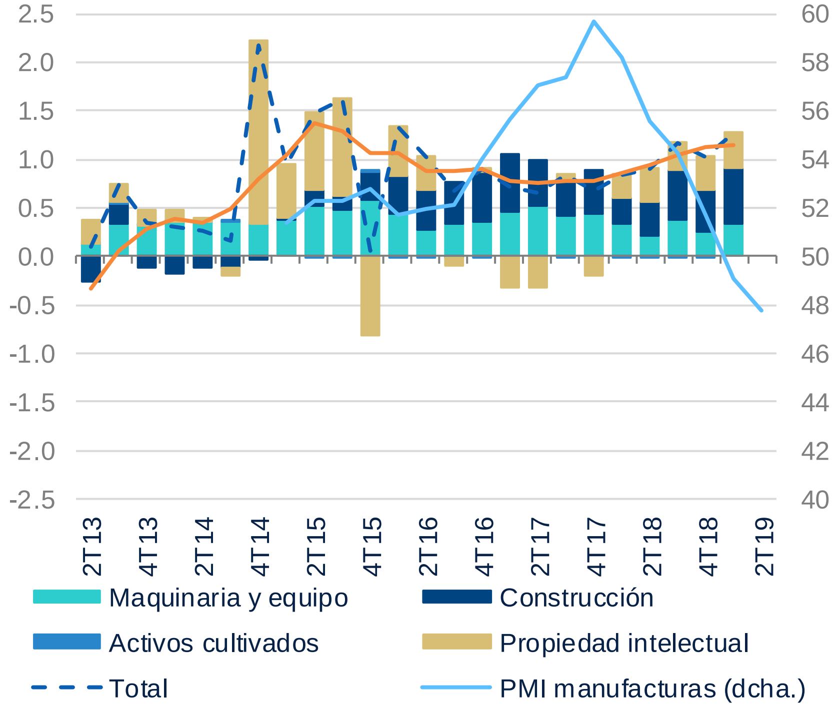
Eurozone: Exports (national accounts), EURUSD and World GDP



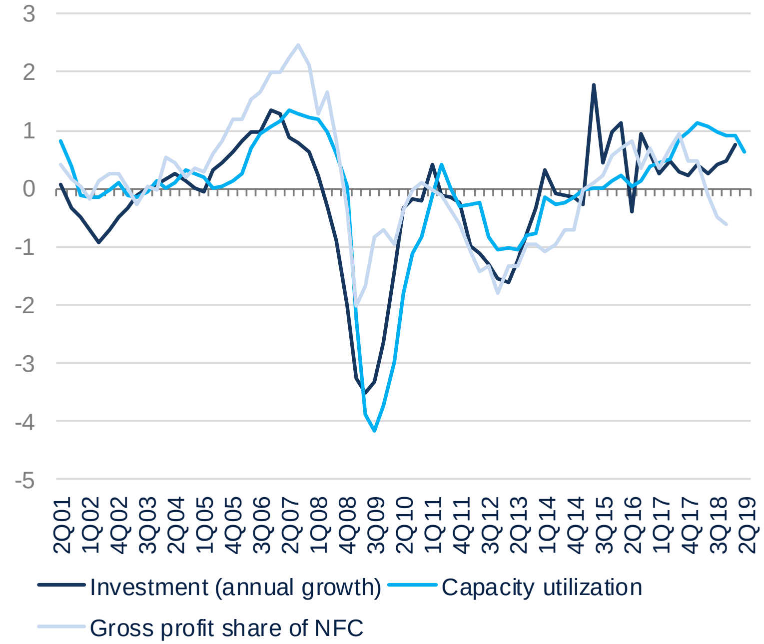
Source: BBVA Research

Investment has been strong across sectors, but higher uncertainty and lower profits point to a moderation in coming quarters

Eurozone: Investment and confidence (% smooth QoQ, level)



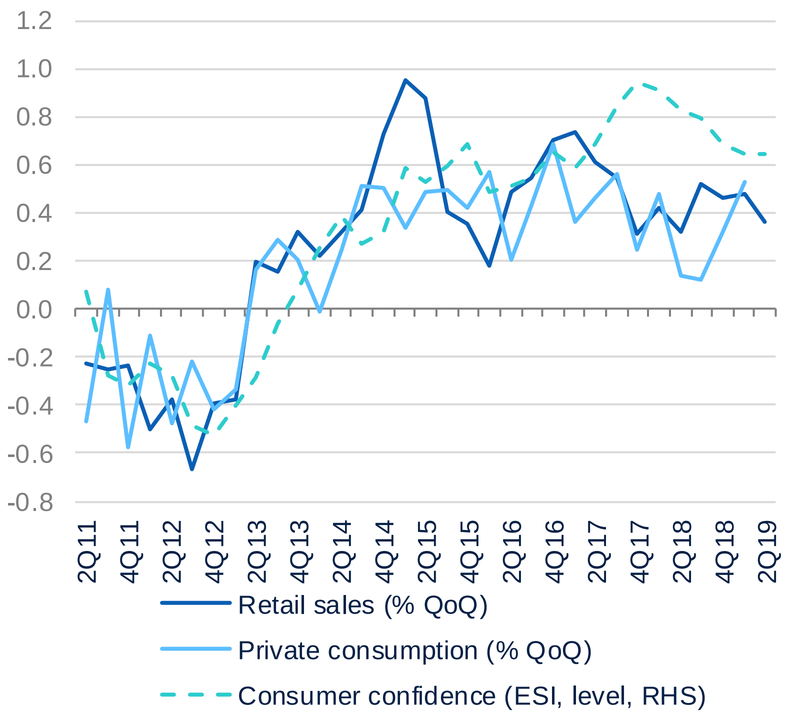
Eurozone: Investment, capacity utilization and profit share (normalized)



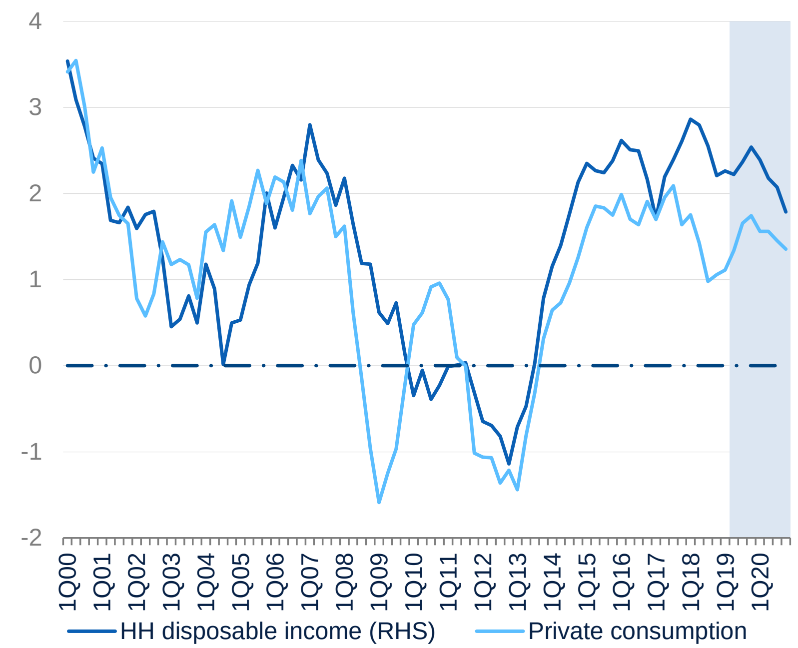
Source: BBVA Research

Consumption has been the main driver of growth, underpinned by real labor income, but is likely to moderate next year…

Eurozone: Private consumption, retail sales and ESI consumer confidence (% QoQ, level)



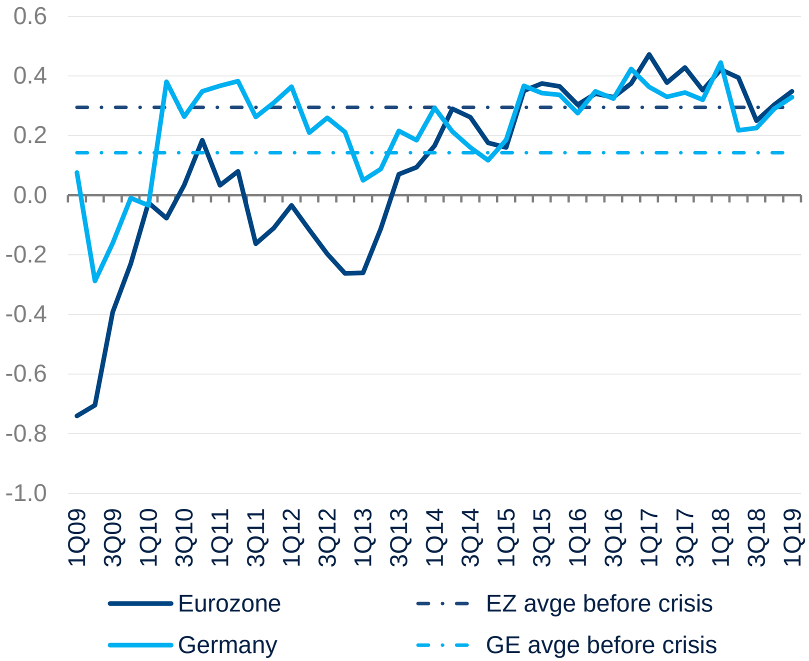
Eurozone: Private consumption and real labour income (% YoY)



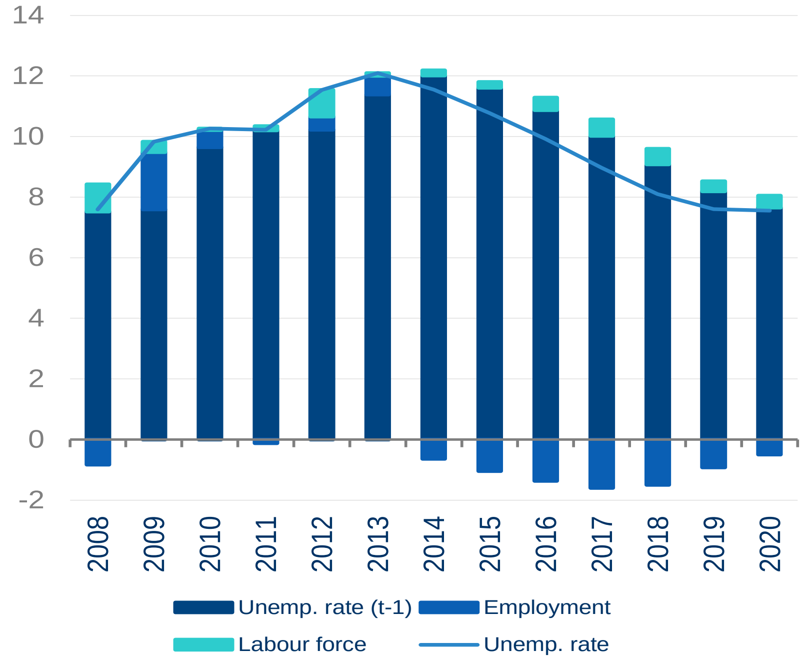
Source: BBVA Research

… as job creation could moderate, with increasing signs of labor market tightening in core countries

Eurozone: Employment (% QoQ)



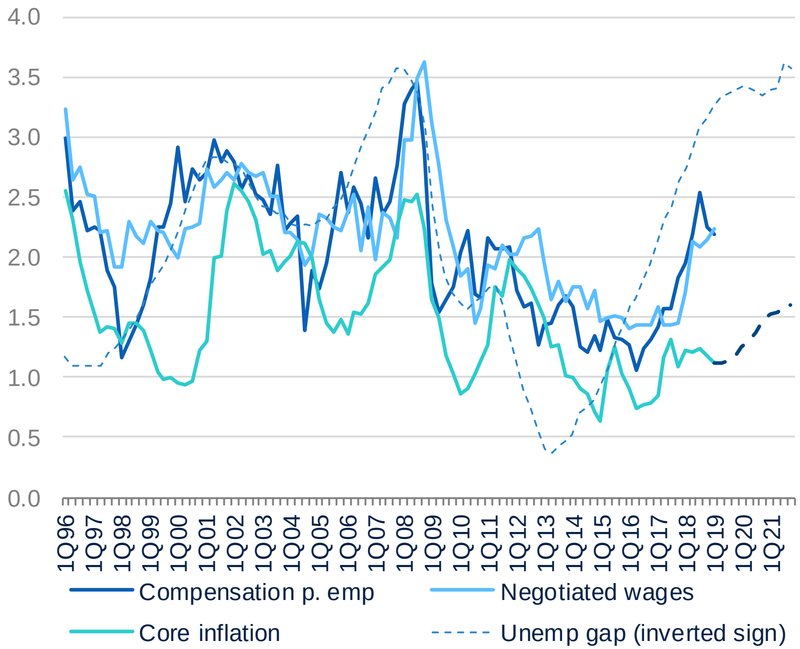
Eurozone: Unemployment rate and contributions (%, pp)



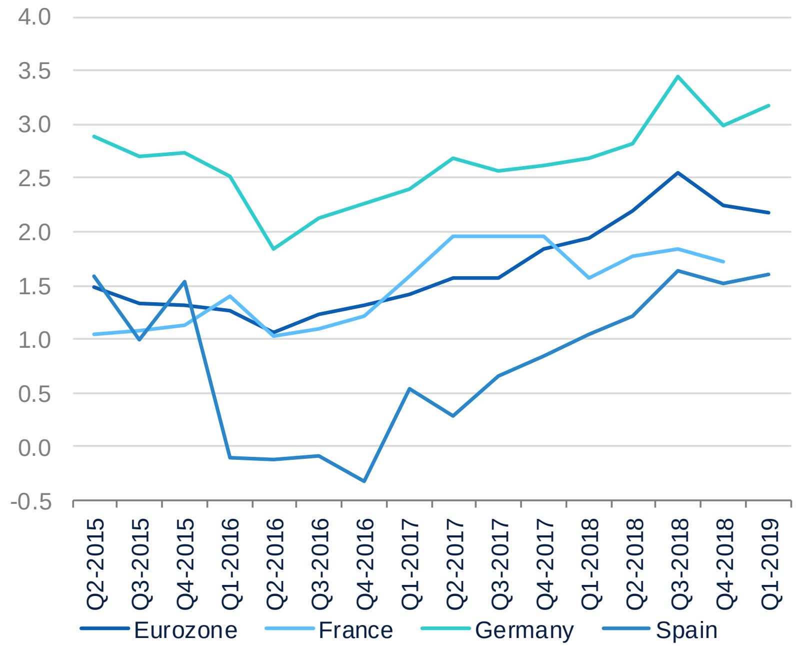
Source: BBVA Research

Wage pressures still fail to pass-through to core inflation

Eurozone: Inflation and wages (% YoY)



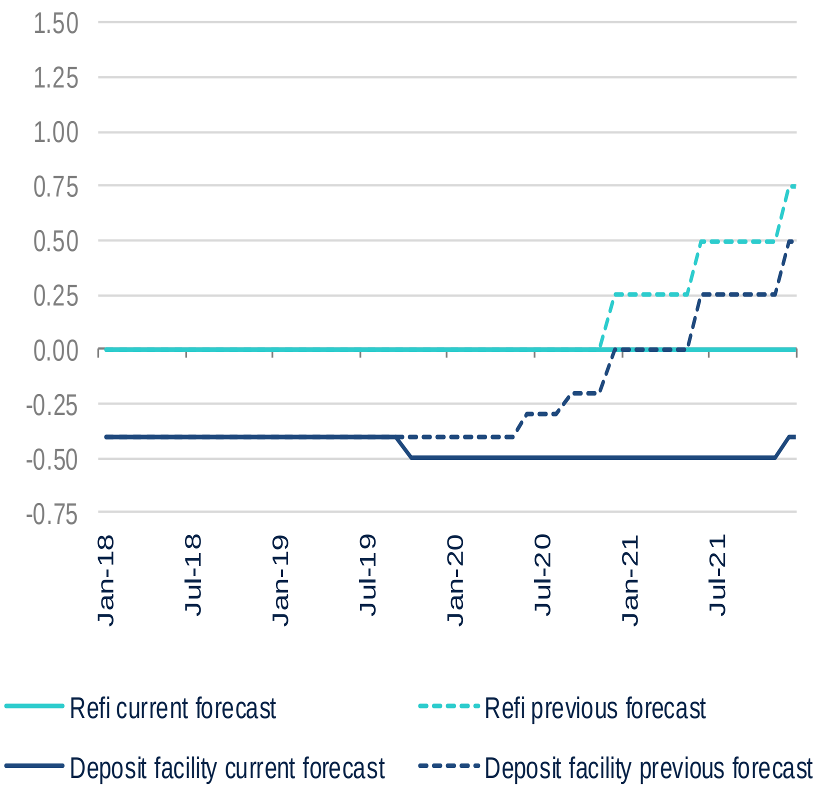
Compensation per employee by country (% YoY)



Source: BBVA Research

Global uncertainty and lower inflation have led the ECB to switch from monetary normalization to opening to new accommodation

ECB: interest rates (%, end of period)



Source: BBVA Research

- Growth risks and very low inflation set the stage for lower rates for longer
- ECB is now expected to
  - Strengthen forward guidance
  - Cut depo rate by 10bps in 3Q19
  - Adopt a tiered deposit system

  ... and is also open to more QE if needed
- Balance sheet: higher, due to the launch of TLTRO-III and extended reinvestment of QE (since rate hikes are delayed)
- ECB presidency: The nomination of Lagarde at the ECB should not lead to a significant change in monetary policy

Eurozone's new projections: Slightly softer growth due to the persistence of industry weakness and uncertainty (trade and Brexit)

Main macroeconomic indicators
(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**2.5**	**1.9**	**1.1**	**1.2**
Private consumption	1.8	1.3	1.5	1.5
Public consumption	1.3	1.0	1.2	1.3
Investment	3.0	3.3	3.0	2.1
Domestic Dem. (cont. pp)	**1.8**	**1.7**	**1.4**	**1.5**
Exports	5.4	3.2	2.5	2.3
Imports	4.1	3.2	3.4	3.3
Net Exports (cont. pp)	**0.8**	**0.1**	**-0.3**	**-0.3**
Current account (% GDP)	**3.2**	**2.9**	**2.6**	**2.4**
Budget balance (% GDP)	**-1.0**	**-0.5**	**-0.9**	**-1.1**
HICP (avg. %YoY)	**1.5**	**1.8**	**1.2**	**1.4**

Source: BBVA Research

- GDP forecasts slightly revised up from 1.0% to 1.1% in 2019 and down from 1.3% to 1.2% in 2020
- Growth moderation is mainly centered on exports and investment, which reflect the external demand moderation and lingering uncertainties
- Private consumption is holding up relatively well, but the risk is that a gloomier activity outlook drive it down
- Headline inflation revised downward in 2019-20, declining to 1% over 2H19 due to energy prices. Core inflation remains low but should increase gradually due to labor market tightness and higher wage growth in coming months, but below the ECB target

Higher uncertainty on several domestic fronts adds to global concerns on trade war

Brexit

- Boris Johnson elected new PM, advocates to deliver **Brexit on October 31** even without a deal, despite a Parliamentary majority's rejection of a no-deal Brexit
- Very open **outcomes**: (i) a renegotiated (or **dressed up) May's agreement under Johnson (40%);** (ii) a pre-Brexit snap **election that could extend Brexit by 3-6 months**, with an uncertain outcome (**30%**); (iii) **No-deal Brexit on October 31 (30%)**

Italy

- The EC decided not to trigger the Excessive Deficit Procedure for Italy after adjusting this year's budget by 0.4pp to push the deficit down to 2%; still, **tensions could surge by year-end due to the lack of measures for 2020** (and tax cuts in the pipeline). **Risk of early elections is high**

EU

- European elections: More fragmented Parliament, but **mainstream parties hold** (EPP: 24%; PES: 21%; Liberals: 14%; Green: 10%)
- **Top jobs:** (i) Ms. **Von der Leyen** as EC President: **federalist and** pro-Europe, but doubts about her real weight; (ii) Ms. **Lagarde as ECB President**: **continuity** of accommodative monetary policies, supported by the ECB chief economist Phillip Lane and the technical Staff
- **Deepening Eurozone integration and strengthening the role of fiscal policy could make some progress**, specially due to exhaustion of the monetary policy. **Supporters seem to gain ground** (Macron's pro-Europe views strengthened after European elections, Ms. Lagarde, Ms. Von der Leyen), but **still strong opposition** (Netherlands, Hanseatic League in general, Italy's problems)

Germany: Subdued external demand and increasing trade uncertainty is weighing on industry, but strong domestic drivers support growth

Main macroeconomic indicators

(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**2.5**	**1.5**	**0.8**	**1.2**
Private consumption	2.0	1.1	1.5	1.4
Public consumption	1.6	1.0	1.5	1.4
Investment	3.6	2.7	2.5	2.1
Domestic Dem. (cont. pp)	**2.1**	**1.8**	**1.4**	**1.4**
Exports	5.3	2.2	1.5	1.9
Imports	5.3	3.4	3.1	2.5
Net Exports (cont. pp)	**0.3**	**-0.4**	**-0.6**	**-0.2**
Current account (% GDP)	**8.0**	**7.4**	**6.8**	**6.4**
Budget balance (% GDP)	**1.0**	**1.7**	**1.0**	**0.7**
HICP (avg. %YoY)	**1.6**	**2.0**	**1.4**	**1.5**

Source: BBVA Research

- The slowdown in trade and increasing uncertainty on protectionism are taking their toll on an export-oriented economy, especially on the industrial sector
- Domestic fundamentals remain strong (solid job creation, higher wages, elevated service confidence). Private consumption has been stimulated by fiscal measures with a positive effect on retail sales and consumer services
- But the protracted weakness of manufacturing threatens the resilience of domestic demand, especially investment
- The government has fiscal room to take action if necessary

France: Growth above EZ average due to stronger domestic demand, driven by fiscal measures, and to less exposure to external demand

Main macroeconomic indicators
(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**2.4**	**1.7**	**1.3**	**1.5**
Private consumption	1.6	0.9	1.2	1.3
Public consumption	1.5	0.8	1.2	1.2
Investment	5.0	2.8	2.4	2.3
Domestic Dem. (cont. pp)	**2.5**	**1.0**	**1.5**	**1.5**
Exports	4.0	3.5	2.6	2.0
Imports	4.1	1.2	3.0	2.1
Net Exports (cont. pp)	**-0.1**	**0.7**	**-0.2**	**-0.1**
Current account (% GDP)	**-0.6**	**-0.6**	**-0.7**	**-0.6**
Budget balance (% GDP)	**-2.9**	**-2.6**	**-3.2**	**-2.5**
HICP (avg. %YoY)	**1.2**	**2.1**	**1.1**	**1.3**

Source: BBVA Research

- Domestic demand is expected to be the main driver of growth, with private consumption expected to gain momentum over the forecast horizon (favorable labor market and fiscal measures led significant gains in households purchasing power)
- Investment is expected to slow but will remain relatively robust supported by high capacity utilization and public investment
- Exports remain relatively resilient compared with other Eurozone member states, but the dynamism of imports could lead to a negative contribution of net exports.
- Protracted global uncertainty could end weighing on agents' sentiment over the forecast horizon.

Italy: Higher political uncertainty and weaker external demand cold led the economy close to stagnation in 2019-20

Main macroeconomic indicators
(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**1.8**	**0.7**	**0.0**	**0.4**
Private consumption	1.5	0.6	0.3	0.5
Public consumption	0.3	0.2	0.0	0.3
Investment	4.5	3.2	-0.1	1.0
Domestic Dem. (cont. pp)	**1.5**	**0.8**	**0.1**	**0.5**
Exports	6.4	1.4	1.9	1.8
Imports	5.8	1.8	2.3	2.2
Net Exports (cont. pp)	**0.3**	**-0.1**	**-0.1**	**-0.1**
Current account (% GDP)	**2.6**	**2.5**	**2.6**	**2.5**
Budget balance (% GDP)	**-2.4**	**-2.1**	**-2.3**	**-2.9**
HICP (avg. %YoY)	**1.3**	**1.2**	**0.8**	**0.9**

Source: BBVA Research

- Very weak domestic demand over the forecast horizon as higher uncertainty could offset the potential positive short-term effect of fiscal …
- … as well as hit firms' decision on both hiring (recent worsening in the labor market) and investing
- Fiscal stimulus will not fix Italian structural problems (low productivity and potential growth), while it could raise concerns on public accounts sustainability and trigger a tough debate with Europe about fiscal targets in the Autumn

Spain: The economy is gradually decelerating, but still at solid pace in the forecast horizon compared to other member states

Main macroeconomic indicators
(% YoY, % GDP)

	2017	2018	2019 (f)	2020 (f)
Real GDP	**3.0**	**2.6**	**2.3**	**1.9**
Private consumption	2.5	2.3	1.8	1.7
Public consumption	1.9	2.1	1.8	1.7
Investment	4.8	5.3	3.1	3.4
Domestic Dem. (cont. pp)	**2.9**	**2.9**	**2.0**	**2.1**
Exports	5.2	2.3	1.7	3.5
Imports	5.6	3.5	0.8	4.1
Net Exports (cont. pp)	**0.1**	**-0.3**	**0.3**	**-0.1**
Current account (% GDP)	**1.8**	**0.9**	**0.7**	**0.4**
Budget balance (% GDP)	**-3.0**	**-2.5**	**-2.2**	**-1.9**
HICP (avg. %YoY)	**2.0**	**1.7**	**0.8**	**1.3**

Source: BBVA Research

- Better-than-expected performance in 1H19, but with a smaller contribution of domestic demand
- Growth slowdown will be driven by exhaustion of the fiscal stimulus, private consumption, regulatory changes in the construction sector and lower external demand
- The expansionary monetary policy and the reduction of risk premium will support growth, but there is uncertainty about the impact of additional ECB's measures…
- … as well as the policies that will be implemented in Spain

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