

The ECB strengthens its precautionary tone on downside risks to the economy

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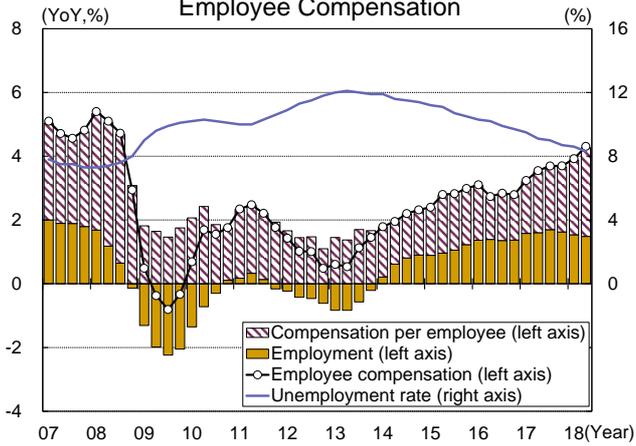
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Eurozone growth has been slowing since last year, but there was still a robust expansion of 0.4% quarter-on-quarter (QoQ) in Q2 2018. Looking at the breakdown by expenditure components, net exports made a negative contribution for a second consecutive quarter, but gross fixed capital formation (GFCF) was a driver of growth. Robust growth continues to be supported by increasing private consumption, employment and wages (Chart 1). It is in this context that the European Central Bank (ECB) left monetary policy unchanged at its monetary policy meeting on 13 September. The ECB's GDP forecast, which was published at the same time, was revised down slightly from the previous release in June, but the latest figures of 2.0% YoY for 2018, and 1.8% YoY for 2019 remain above the euro area's potential growth rate. On the economic outlook, the ECB stated that 'The risks surrounding the euro area growth outlook can still be assessed as broadly balanced'. At the same time, it is important to note that the ECB strengthened its precautionary tone on downside risks, stating that 'uncertainties relating to rising protectionism, vulnerabilities in emerging markets and financial market volatility have gained more prominence recently'.

Taking a broad view of the economic environment around Europe, it is worth bearing in mind that despite the robust economy, uncertainty about the future is increasing. On one hand, trade talks between the EU and the US in late July seem have averted a tit-for-tat trade war for the time being. The German Ifo business sentiment index, which had been on a declining trend, has also recently improved markedly, particularly the expectations index (Chart 2). However, the effects of sharply increased trade tensions between the US and China on the global economy remain to be seen. The future of US-EU automotive tariffs also remains clouded. There are a number of events unfolding in and around Europe at the moment which have the potential to upset financial markets: Brexit negotiations, the situation in Turkey and fears over Italian fiscal policy. The ECB will terminate net asset purchases by the end of this year and seems to be planning to proceed with monetary policy normalisation by raising the deposit facility rate next autumn. However, like the normalisation process carried out by the US Fed, it is possible that the ECB may end up having to delay its exit strategy depending on movements in financial markets and the real economy.

Chart 1: Eurozone Unemployment rate, Employment, Employee Compensation



Source: Eurostat, ECB, MUFG Bank Economic Research Office

Chart 2: German Ifo Business Climate Index



Source: Ifo, MUFG Bank Economic Research Office

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