Brighter European growth prospects

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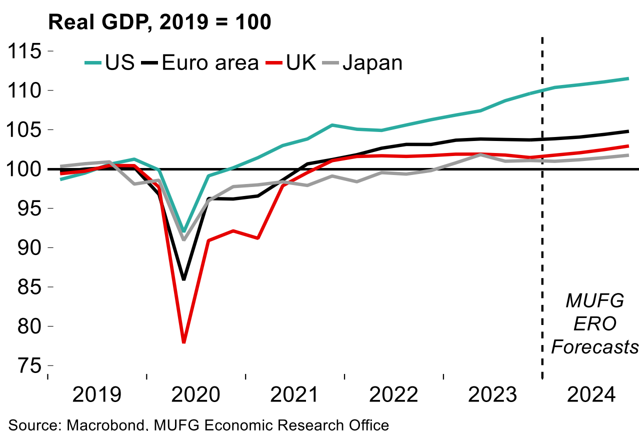
- Our view on the European economy remains constructive this year. We look for a degree of cyclical improvement over coming quarters as households' real purchasing power recovers and central banks start to ease policy. Growth is set to pick up towards potential rates by year-end.
- Improving global conditions mean that the conditions are also now there for a cyclical recovery in German industry. Structural headwinds remain, but survey evidence now points to better output over coming months.
- We remain confident that the European disinflation process remains on track. In isolation, both the ECB and BoE are approaching the point where a degree of easing would be appropriate – but the topic of divergence with the Fed will remain in focus if US data continues to come in hot.

European growth prospects have brightened

The macroeconomic situation in Europe has essentially been one of stagnation since the pandemic rebound effect faded (Chart 1). Activity at the end of 2023 was notably weak: growth was flat in the euro area as a whole but there was a sharp contraction in Germany in Q4, while the UK economy slipped into a technical recession.

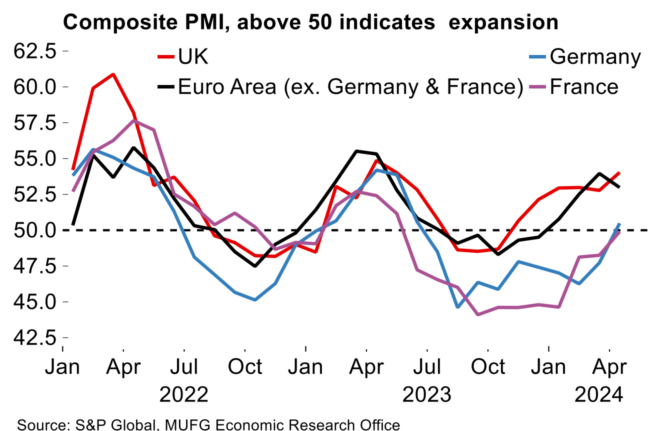
Recent survey data shows that the European economy has started the year on a firmer footing (Chart 2), and we expect that growth conditions will continue to gradually improve. We are tracking euro area GDP at 0.2% Q/Q in Q1 (data to be released next week). We look for slightly firmer growth in the UK in Q1 (0.3% Q/Q), which would be a healthy bounce after what was a short recession. Growth rates in both economies are set to pick up further towards potential on an annualised basis by year-end. Better real income growth is reflected in surveys – euro area consumer confidence is at a two-year high – and household consumption is set to be the key driver of overall activity this year in Europe.

Chart 1: Muted European growth since 2022



Source: Macrobond, MUFG Economic Research Office

Chart 2: Signs of better momentum in H1 2024



Source: S&P Global, MUFG Economic Research Office

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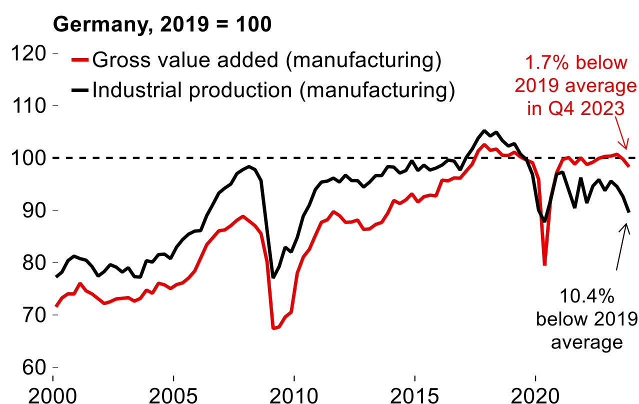
Taking a wider view, global sentiment continues to be supported by a resilient US economy where recent data shows still-robust consumer spending. Our US economist notes that high interest rates, depleted household savings and deteriorating credit conditions suggest that US growth is on course to slow later this year. But, for now, the ongoing strength in activity and diminished fears over a US 'hard landing' have likely contributed to firmer sentiment elsewhere. The global manufacturing PMI (excluding the US) is now above the break-even mark for first time in over two years, with export data starting to suggest that global trade flows are recovering from a period of stagnation. There are also signs in the official data that the Chinese economy has started 2024 in better shape which provides further encouragement for global activity.

Improving cyclical momentum in German industry

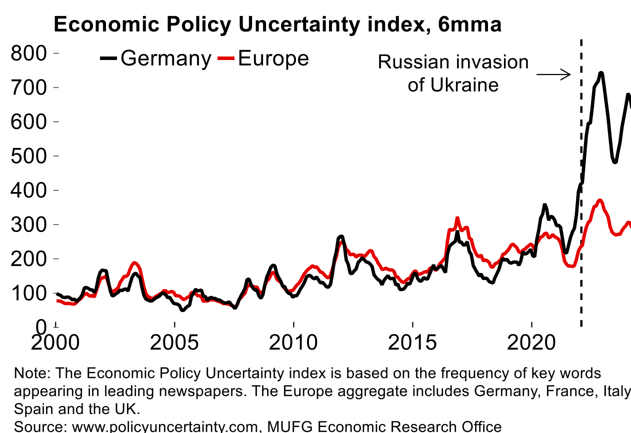
In Europe, better global momentum is good news for the beleaguered German manufacturing sector. The headline figures are stark: German industrial production is 11.5% below the peak recorded in late 2017. We think these figures overstate the problem – gross value added in manufacturing, which provides a more complete picture, is not nearly as bad (Chart 3). That may reflect German firms producing higher quality goods and expanding margins, or onshoring more of production processes. The steeper fall in manufacturing hours worked also points to some productivity gains.

Chart 3: IP and GVA paint different pictures



Source: Statistisches Bundesamt, MUFG Bank Economic Research Office

Chart 4: Elevated policy uncertainty in Germany



Note: The Economic Policy Uncertainty index is based on the frequency of key words appearing in leading newspapers. The Europe aggregate includes Germany, France, Italy, Spain and the UK.
Source: www.policyuncertainty.com, MUFG Economic Research Office

Nonetheless, there are clear structural headwinds for German industry which will persist. Higher energy costs continue to place German industry at a comparative disadvantage vis-à-vis the US and other producers, and there are indications that China is building market share in the auto-sector through EV exports. The issue of shortages of skilled labour is also likely to remain, as is uncertainty around the situation in Ukraine which has likely weighed heavily on sentiment in Germany (Chart 4).

But the conditions are there now for a cyclical recovery, at least, given signs of stronger manufacturing activity and better global trade flows. For a capital-intensive sector, the prospect of ECB easing will also be welcome. Headline industrial production rose by a healthy 2.1% M/M in the latest data from February, while the expectations component of the reliable German ifo survey has picked up meaningfully in the manufacturing sector. All told, we are increasingly confident that, while structural issues remain, the German industrial sector will cease acting as a brake on overall euro area activity through the remainder of this year.

Monetary policy divergence remains in focus

There is a risk that sentiment could be punctured somewhat if central banks do not deliver the expected degree of monetary easing. The ECB has clearly signposted that

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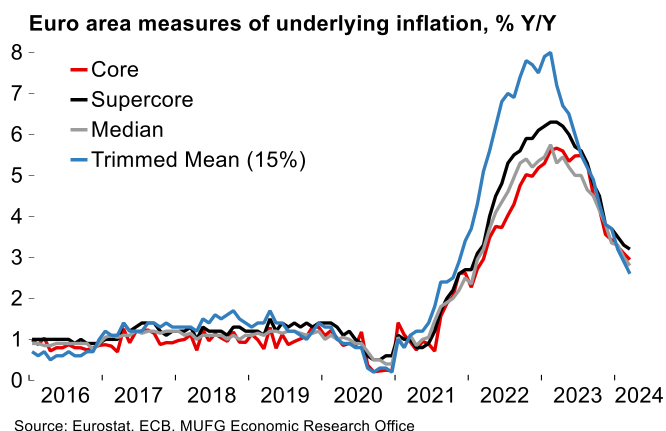
it intends to cut rates at its June policy meeting, and the Bank of England has also signalled that cuts are coming this year (see here and here for our take on their recent policy meetings). However, the paring back of Fed rate cut expectations amid persistent US inflation and still-strong growth has complicated the outlook. The ECB and the BoE have each indicated that they would be comfortable easing policy before the Fed's first rate cut, but both are likely to be a little wary about the effect of weaker domestic currencies on inflation as a result of cross-Atlantic policy divergence.

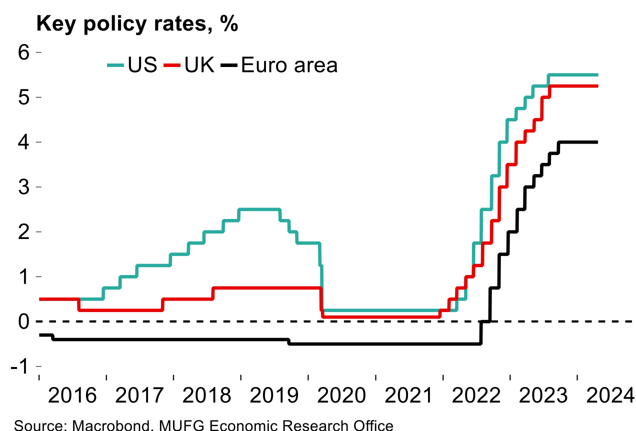
The UK has relatively recent experience of currency pass-through to inflation: the sterling shock following the Brexit referendum pushed headline CPI up to 3.1% in late 2017 (context is important now – the 2014-16 average rate was just 0.7%). While household inflation expectations have drifted downward in Europe, policymakers will be cautious around any factors that might dislodge this process. The recent path of inflation may make it harder for policymakers to look through smaller shocks that may have been ignored in the past. Energy price developments will also be subject to extra scrutiny, with Brent moving above 90 USD/bbl earlier this month.

Chart 5: Underlying inflation continues to ease



Source: Eurostat, ECB, MUFG Economic Research Office

Chart 6: The synchronised tightening cycle



Source: Macrobond, MUFG Economic Research Office

Our view remains that the disinflation trend in Europe (Chart 5) will continue. Given the recent stickiness in US price pressures, it's important to highlight that core inflation is still strongly affected by energy prices, especially in the less wage-sensitive components, with a lag. That means the effects of the Europe-focused energy shock will likely continue to unwind from core metrics in euro area and UK data. On demand, we do expect a gradual growth recovery this year in both the euro area and UK, as noted above, but we think any meaningful acceleration remains unlikely with the effects of prior monetary policy tightening still passing through to the real economy. The risks of an 'overheating' European economy are low.

All told, inflation remains on course to approach target rates over coming months and, in isolation, a shift to monetary easing seems appropriate on this side of the Atlantic. However, the degree of synchronisation during the tightening phase was revealing. Both the ECB (after a delayed start) and the BoE were essentially mirroring the Fed in terms of timing and the magnitude of rate hikes (Chart 6). This was despite different inflation drivers and growth backdrops with demand significantly more relevant in the US. Given that recent experience, it seems reasonable to expect a degree of synchronisation with the Fed on the way down as well – although initial divergence is plausible (and perhaps likely now). This is now a source of risk for the European economy. A delayed start to the US easing cycle increases the chances that monetary policy will remain too tight for too long elsewhere. That could weigh on what should still be considered a fledgling European recovery despite evidence of better cyclical momentum in recent months.

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