The Outlook for European Economies

Economic growth forecast to slow due to Brexit, yet will maintain a trend of recovery

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1. Eurozone

(1) Current Situation

The Eurozone economy has continued to recover gradually up until now. In Q4 last year, the real GDP growth rate grew resiliently: up 0.4% quarter-on-quarter (QoQ). While a breakdown by expenditure has not yet been released, private consumption does appear robust, owing to strong growth of 0.8% QoQ in real retail sales, especially that of durables. GDP data by country reveals that growth in the Netherlands and Italy decelerated, while it accelerated in Germany and France (Table 1). Looking at the breakdowns by expenditure published by major countries so far, Germany's private consumption increased 0.3% QoQ, growth in construction investment accelerated to 1.6% QoQ and growth in exports turned to positive territory, up 1.8% QoQ. In France, lower temperatures led to an increase of energy consumption, such as electricity, and, along with a rise in automotive purchases, contributed to an increase in private consumption of 0.6% QoQ. This, along with an increase in business investment, particularly in investment in equipment and machinery in the manufacturing sector, underpinned the robust growth in domestic demand. Furthermore, exports accelerated 1.1% QoQ, especially transport equipment.

(2) Outlook

The Eurozone economy is forecast to continue to recover, led by domestic demand. Private consumption is expected to be somewhat sluggish in the coming months as a rise in prices will result in a decline of real purchasing power. Business investment is also unlikely to experience the same growth as last year. That being said, the trend of recovery will, on the whole, remain on track as the unemployment rate is forecast to decrease due to an improved supply and demand of labour. On top of this, businesses' profits will rise and the capital utilisation rate will increase. As for external demand, it will continue to increase gradually. Although exports to the UK are expected to become sluggish, exports to the US are predicted to recover due to an acceleration of the country's economy. As a result, the Eurozone's real GDP growth rate is forecast to grow 1.5% YoY this year (Chart 1).

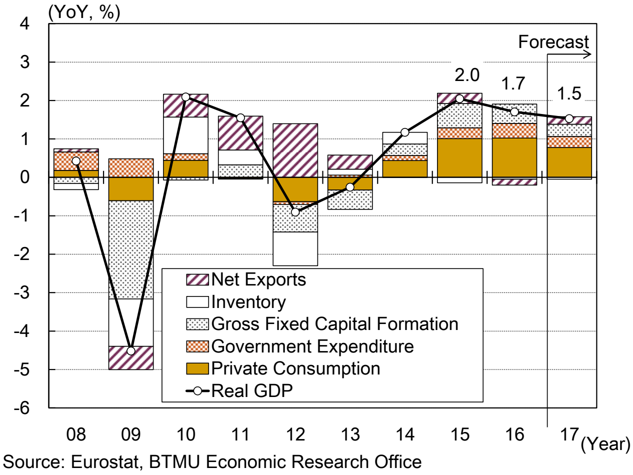
Table 1: Eurozone Real GDP

(QoQ, %)

	2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Eurozone	0.8	0.4	0.3	0.5	0.5	0.3	0.4	0.4
Germany	0.2	0.5	0.2	0.4	0.7	0.5	0.1	0.4
France	0.6	0.0	0.4	0.2	0.6	-0.1	0.2	0.4
Italy	0.3	0.3	0.1	0.2	0.4	0.1	0.3	0.2
Spain	1.0	0.8	0.9	0.8	0.8	0.8	0.7	0.7
Netherland	0.6	0.1	0.2	0.3	0.7	0.7	0.8	0.6
Greece	0.7	0.0	-1.7	1.6	-0.6	0.3	0.9	-0.4

Source: Eurostat, BTMU Economic Reserech Office

Chart 1: Eurozone Real GDP



Source: Eurostat, BTMU Economic Research Office

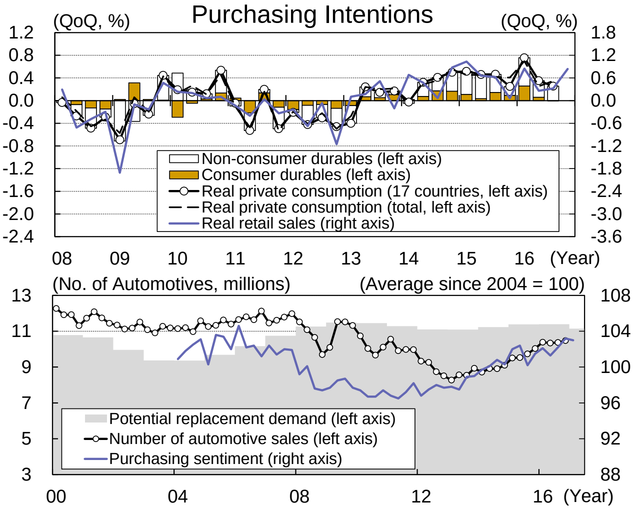
(3) Key Points

① Growth of private consumption will slow somewhat owing to downward pressure from rising prices.

Private consumption grew resiliently in Q4 2016, supported by a continued improvement in labour market conditions. Real retail sales also showed strong growth: 0.8% QoQ (Chart 2 upper). One of the factors contributing to this strong growth is the good performance of automotive sales, which has a considerable impact on the consumption of durable goods. Automotive sales grew 7.1% YoY in 2016 due to demand from those who had refrained from buying a replacement; sales in the final quarter of 2016 continued to show strong growth, up 1.0% QoQ in Q4 (Chart 2 lower).

Looking ahead, downward pressure on households' real purchasing power from rising inflation will cause growth of real income to slow (Chart 3 upper). Meanwhile, growth of automotive sales has been a leading driver of private consumption up until now and although it is unlikely to accelerate further, it will be underpinned by continued replacement demand. Furthermore, the recent rise in businesses' employment intentions shows that employment appetite is not receding, and the current level of unemployment suggests that there is scope for improvement in the labour market. It is unlikely that private consumption will stall as it is supported by further improvement in labour market conditions.

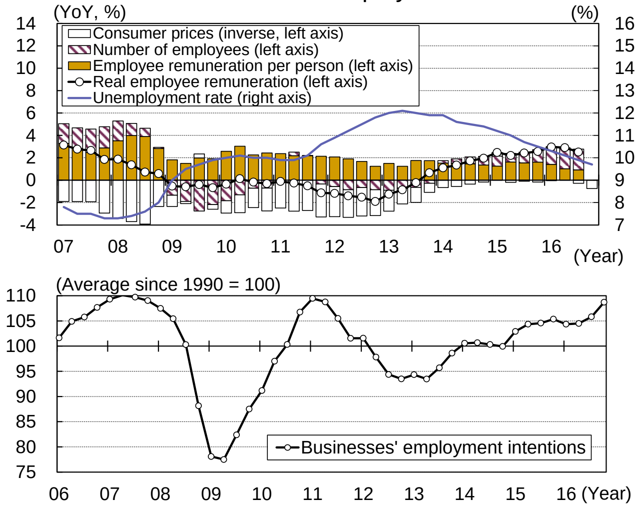
Chart 2: Eurozone - Real Private Consumption and Real Retail Sales, Automotive Sales and Purchasing Intentions



Note: 1. "17 countries" are Eurozone countries excluding Belgium and Ireland, which do not publish a breakdown.
2. "Number of automotive sales" are annualised values based on new car registrations
3. "Potential replacement demand" is calculated using the average number of years that passenger vehicles are used (9 years).

Souce: Eurostat, European Central Bank, European Commission, BTMU Economic Research Office

Chart 3: Eurozone - Real Income, the Unemployment Rate and Businesses' Employment Intentions



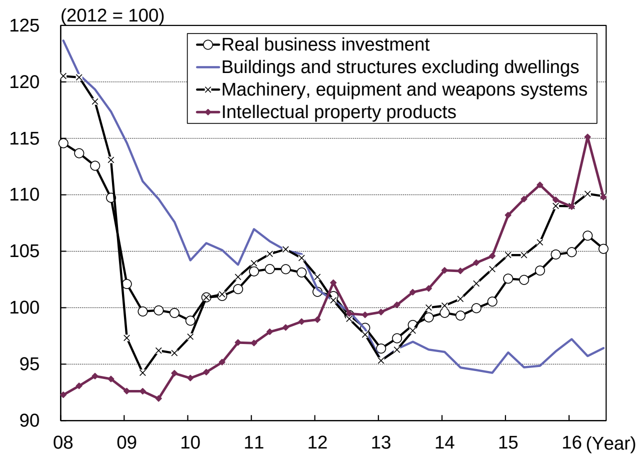
Note: "Businesses' employment intentions" is an average of the manufacturing, retail and service sectors.

Souce: Eurostat, European Commission, BTMU Economic Research Office

② Business investment is forecast to recover at a gradual pace

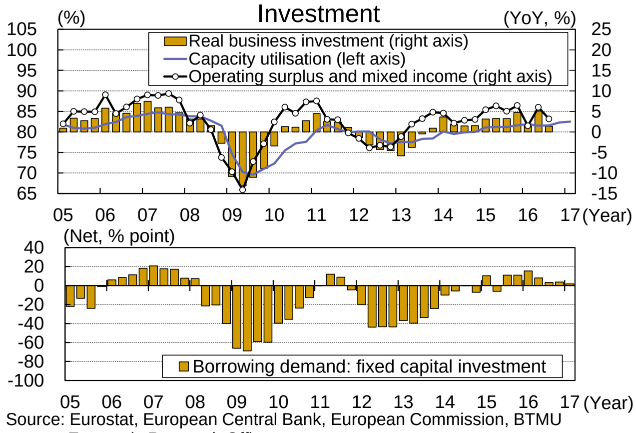
Business investment is being led by increased investment in equipment and machinery. However, due to a slow recovery of non-dwellings building and structures investment, the growth of business investment remains at a slow pace (Chart 4). Business investment is forecast to maintain an upward trend due to a rise in capacity utilisation rates and a continued increase in businesses' profits. However, there is no clear sign that borrowing demand related to businesses' fixed capital investment will grow despite looser financial conditions (Chart 5). As pent-up demand accumulated during the European debt crisis is anticipated to fade, growth in business investment is expected to be limited to a gradual pace.

Chart 4: Eurozone - Breakdown of Business Investment



Source: Eurostat, BTMU Economic Research Office

Chart 5: Eurozone - Capacity Utilisation Rate, Real Business Investment, Operating Surplus and Borrowing Demand related to Businesses' Fixed Capital Investment

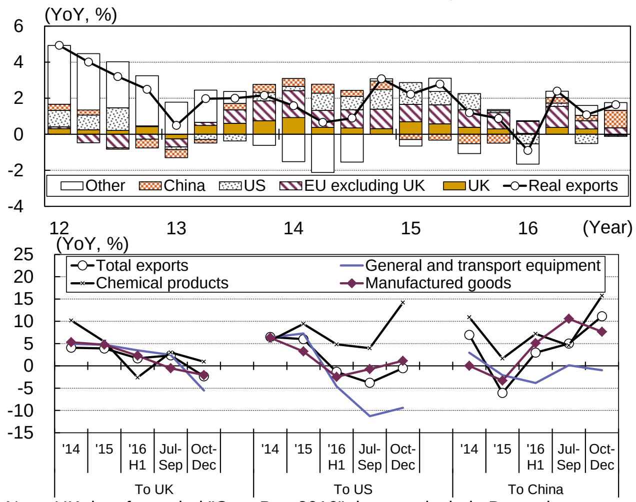


Source: Eurostat, European Central Bank, European Commission, BTMU Economic Research Office

③ Sluggish exports to the UK will be compensated by a recovery in the US

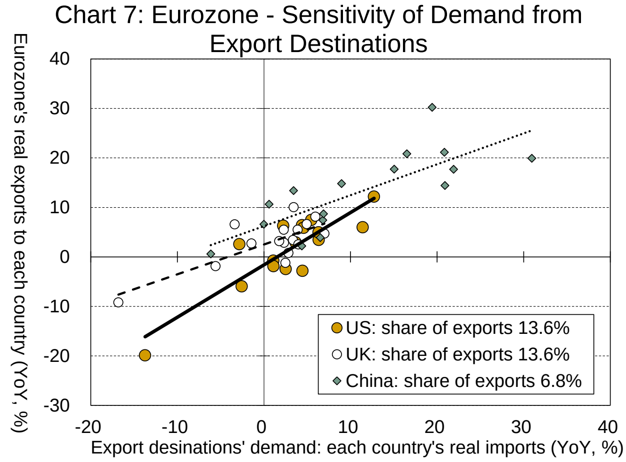
Growth in exports (on a customs basis) were sluggish in Q4 last year due to a decrease in exports to the US and UK, both of which are major export destinations for the Eurozone. Nevertheless, an increase in exports to China contributed to an acceleration of growth to 1.6% YoY (Chart 6). A breakdown by major destination and item shows that the growth of exports to China has been accelerating, particularly that of chemical products and manufactured goods. The decline in exports of general and transport equipment to the US pushed down overall exports, yet the pace of the decline was slower than before, suggesting that exports to the US will bottom out in the future. Meanwhile, exports of general and transport equipment and manufactured goods to the UK decreased; growth in exports of chemical products decelerated. From now, the pace of export growth to the UK is expected to weaken due to a slowdown of the UK economy, but the sensitivity of the Eurozone's exports to changes in US demand (the amount of imports) is higher than that of the UK and China (Chart 7). It appears that overall exports will recover in the coming months as the recovery of exports to the US will counteract the sluggish exports to the UK.

Chart 6: Eurozone - Real Exports



Note: UK data for period "Oct - Dec 2016" does not include December.
Source: Eurostat, BTMU Economic Research Office

Chart 7: Eurozone - Sensitivity of Demand from Export Destinations



Note: Scatter chart covers period 2001 to 2016, share of exports is 2016 data
Source: Various national statistics offices, BTMU Economic Research Office

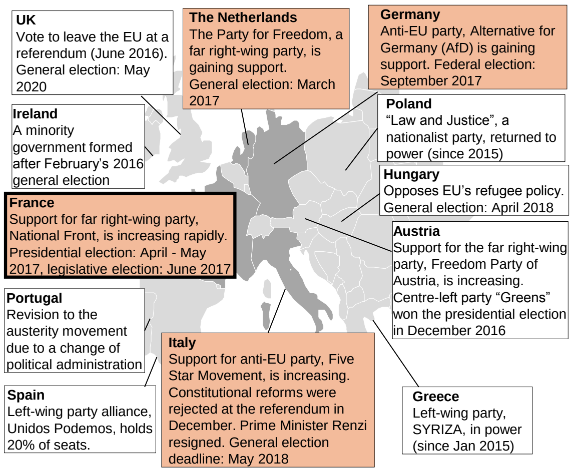
④ European elections will test the cohesive power of the EU

This year, there are important elections planned in EU founding member countries: the Dutch general election in March, the French presidential and legislative elections from April to June and the German federal election in September (Chart 8). In Europe, support for Eurosceptic political parties has grown, especially far-right parties, on the back of claims that the increase in the number of immigrants is the reason for deterioration in the public security of these countries and for the high levels of unemployment. In a survey published by the European Commission in November last year, to the question, "which of the following do you think is the most positive result of the EU?", there were several options to choose from, including "peace" , "the Euro" and "the free movement of people, goods and services within the EU". However, the percentage of people who replied "none" (no positive result) increased in many countries (Chart 9). In addition, the Dutch Party for Freedom, which has made a campaign pledge to hold a national referendum on EU membership, is leading Dutch public opinion polls of the election. In France, there is a possibility that Marine Le Pen, leader of the National Front, will remain on the final ballot. Uncertainty regarding the future of the EU is rising.

That being said, in the case of the result mentioned above, it is likely that the current ruling coalition in the Netherlands, which excludes the Party for Freedom, will take control in the Dutch parliament, where it is normal for minority parties to form a coalition government. In France, approval by the National Assembly is required in order to hold a national referendum on whether or not to leave the EU. It is unlikely that the National Front will gain a majority of seats in the National Assembly at the election in June, which will take place after the presidential elections[1]. Besides, it appears the climate in France is not ready for the realisation of extreme campaign pledges such as leaving the EU, touted by Le Pen. However, if new administrations cannot improve matters, such as the worsening of public security and high levels of unemployment, Eurosceptic public opinion will grow in the future and there is a possibility that Eurosceptic political parties will see a further increase in support and in the number of seats won at the next elections, which will continue to pull the EU apart.

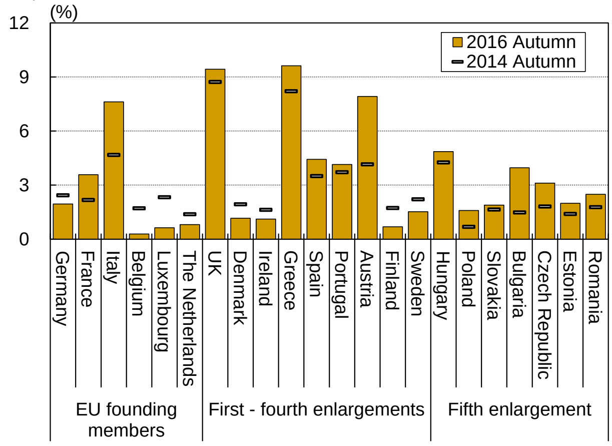
[1] In France, legislative elections adopt single-seat constituency systems in the two rounds. At the previous election in 2012, the National Front gained 14% of the vote, yet only won 2 seats out of 577.

Chart 8: Major Political Trends in Europe



Source: Various news sources, BTMU Economic Research Office

Chart 9: Growing Anti-EU Sentiment of Major EU Members
(Ratio of those who answer "none" when asked about the benefits of the EU)

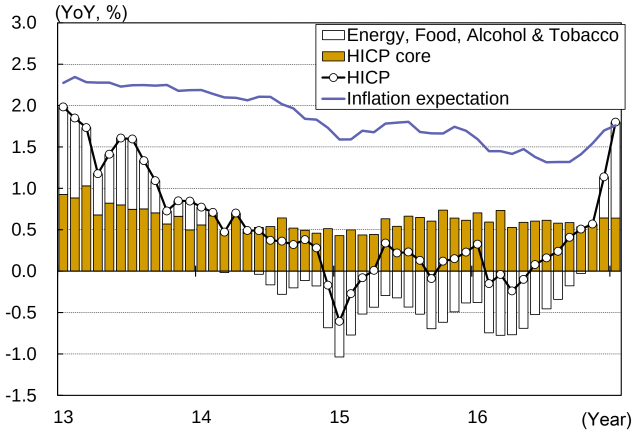


Source: European Commission, BTMU Economic Research Office

(4) Monetary Policy

In January, composite inflation in the Eurozone grew 1.8% YoY, accelerating sharply due to a recovery in resource prices, yet the growth pace of core inflation remains slow (Chart 10). Looking at the relationship between the unemployment rate and wage inflation, pressure on wage inflation has not strengthened as it did in 2000s, despite a reduction of the unemployment rate (Chart 11), suggesting that inflationary pressure is unlikely to increase for the moment. Furthermore, the dovish members of the ECB's Governing Council and the governor of the Bundesbank, one of the hawkish members, also said that "we have not yet at point where it can end expansionary policy". As the ECB needs to monitor the impact of the reduction in the amount of asset purchases, which is planned in April, it is likely that the ECB will maintain its current monetary easing policy and adopt a wait-and-see attitude.

Chart 10: Eurozone inflation



Notes: "Inflation expectation" is 5-year, 5-year EUR inflation swap rate.
Source: Eurostat, Bloomgerg, BTMU Economic Research Office

Chart 11: Eurozone - Employee Remuneration Per Person and the Unemployment Rate

Source: Eurostat, BTMU Economic Research Office

2. UK

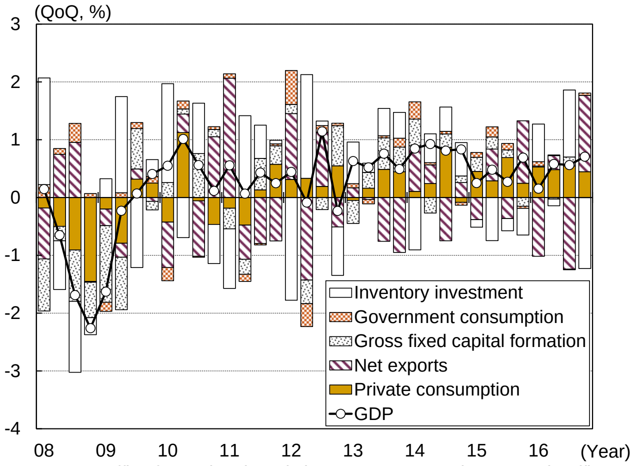
(1) Current situation

Despite the UK's vote to leave the EU at a national referendum last year, the growth pace of its economy has remained resilient up until now. In Q4 last year, the real GDP growth rate increased 0.7% QoQ, exceeding that of Q3 (0.6% QoQ) (Chart 12). While growth of private consumption and fixed capital formation slowed, the growth rate was pushed up by an increased contribution by net exports (exports less imports), which was mainly due to a rise in exports. In Q4, the upturn in exports of goods with greater volatility, such as aircraft and gold, caused a marked increase in overall growth[2]. Therefore, growth in Q1 this year is forecast to slow in response to the previous quarter's strong growth, yet exports appear to be following an upward trend.

[2] In Q4, nominal exports (on a customs basis) increased 10.4% QoQ. The contribution from non-classified commodities, such as gold, was 4.1% points, and the contribution from aircraft was 0.9% points.

Monthly indicators reveal that the increase in the number of employees appears to have peaked, while real retail sales recorded negative growth for the last three months up until January due to a rise in the inflation rate (Table 2). The number of residential property sales remained comparatively resilient as a result of the rate cut by the Bank of England (BoE) in August last year, but growth of outstanding consumer credit appears to have slowed. Meanwhile, the volume of exports is on an upward trend, and the pace of deceleration of net expenditure by tourists (expenditure by inbound foreign tourists less expenditure by outbound UK tourists) slowed for the first time in 7 months. On the whole, growth is underpinned by external demand, despite lacklustre growth in domestic demand.

Chart 12: UK Real GDP



Source: UK Office for National Statistics, BTMU Economic Research Office

Table 2: UK Main Economic Indicators

2016	Aug 2016	Sep	Oct	Nov	Dec	Jan 2017
Real retail sales (MoM, %)	0.3	-0.2	2.1	-0.2	-2.1	-0.3
Number of employees (Compared with previous 3-month period, %)	0.3	0.2	0.0	0.0	0.1	—
Consumer confidence balance (MoM, %)	0.7	0.4	0.7	1.0	0.3	—
Number of property sales (MoM, %)	0.4	-1.1	0.7	0.8	2.7	4.9
Volume of exports (MoM, %)	-0.5	-2.9	3.3	7.3	3.1	—
Net expenditure by foreign tourists (GBP, billions)	-1.78	-1.95	-2.04	-2.08	-1.84	—

Note: "Net expenditure by foreign tourists" is expenditure by inbound tourists less expenditure by outbound tourists.
Source: UK Office for National Statistics, Bank of England, BTMU Economic Research Office

(2) Outlook

The Uncertainty Index, calculated by the BoE, rose to 1.7 directly after the referendum in June last year where the UK voted to leave the EU, but it dropped to 0.3 recently (Chart 13). That being said, it is still above the long-term average of 0, suggesting that future uncertainty has not been cleared. Looking ahead, it is likely that persistent uncertainty will weigh down the economy. The UK government intends to trigger article 50 by the end of March, which will be the starting point of two years of exit negotiations. The UK government's plan is to enter into a comprehensive FTA with the EU, but there is continued uncertainty as the reaction on the EU side is unknown. Moreover, other concerns – such as the risk of a great economic disruption if negotiations are not completed within the two years[3] – will also cause prolonged uncertainty.

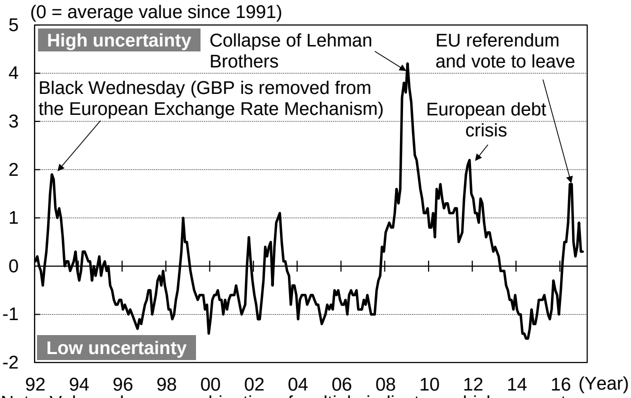
[3] An extension of the negotiation period must be agreed upon by all EU members according to EU rules. If an agreement cannot be reached within two years and the period of negotiations is not extended, then EU Treaties will cease to be applied to the member which has withdrawn (in this case, the UK) as of the end of the negotiation period.

The continued uncertainty surrounding the future will put downward pressure on household and business sentiment and there is a strong possibility that it will curb consumption and investment. Rising inflation will lead to weaker consumer confidence and lower real purchasing power, both of which will drag down private consumption. Furthermore, business investment is already sluggish; it declined in Q4 last year for the fourth consecutive quarter. In a survey of business sentiment, attitudes towards investment appear more reluctant as the process of leaving the EU and the final state of the UK's relationship with the EU are unclear, suggesting sluggish business investment is expected to continue. In addition, the UK government's 2017 budget (from April 2017 to March 2018) takes a fiscally neutral position in relation to the economy, which means that positive support for domestic demand from the government budget is limited.

Growth of the economy as a whole is forecast to decelerate due to a slowdown of domestic demand. Nevertheless, it appears that significant worsening of the economy will be avoided because of the support from foreign demand. Until around autumn last year, the volume of UK exports was on a downward trend, but it picked up towards the end of the year. Globally, manufacturing activities have improved and there are signs of a recovery in trade volumes (Chart 14 upper). It is thought that the trend of a global trade slowdown seen in recent years will continue in the medium to long-term, but, in the short-term, export growth is entering a cyclical phase of recovery.

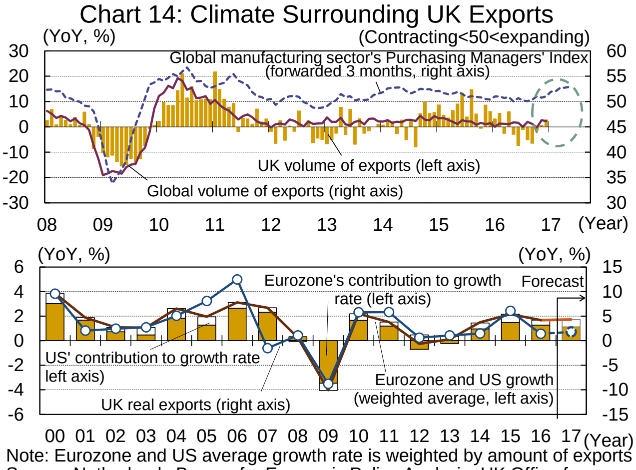
In 2017, the economic growth of the Eurozone, which is one of the UK’s major export destinations (48% of all exports), is expected to decelerate slightly, whereas growth of the US (16% of UK exports) will accelerate significantly. Looking at exports as a whole, the resilient growth of demand from major export destinations is expected to remain relatively unchanged from last year (Chart 14, lower). This, together with the cyclical recovery of the global volume of trade will act as a tailwind for UK exports. The real GDP growth is forecast at 1.1% YoY in 2017, decelerating from 1.8% YoY in 2016, but we expect the UK economy will avoid significant deterioration.

Chart 13: UK Uncertainty Index



Note: Values show a combination of multiple indicators which suggest uncertainty surrounding the future, such as sentiment indices, financial market volatility, the number of related words in newspapers.
Source: Bank of England, BTMU Economic Research Office

Chart 14: Climate Surrounding UK Exports



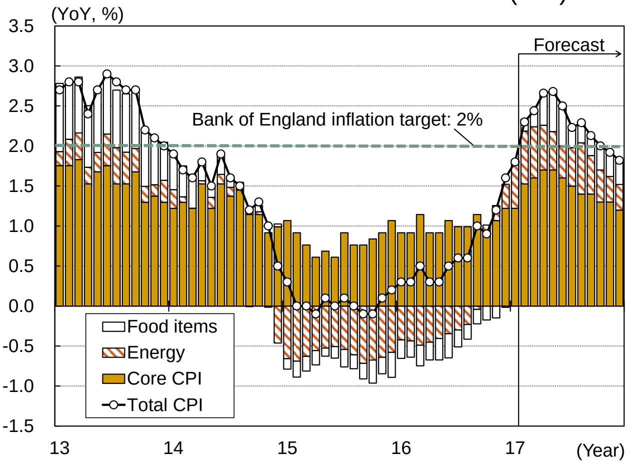
Note: Eurozone and US average growth rate is weighted by amount of exports
Source: Netherlands Bureau for Economic Policy Analysis, UK Office for National Statistics, Markit, Eurostat, US Department of Commerce, BTMU Economic Research Office

(3) Monetary policy

The inflation rate continues to follow an upward trend; the Consumer Price Index (CPI) was 1.8% YoY in January, accelerating to its highest level in two-and-a-half years (Chart 15). The reasons for this are rising import prices due to a recovery of oil prices and pound depreciation. It is thought that the impact of this increase will not fade until the latter half of the year at least. It appears that the pace of CPI increase will accelerate to a level exceeding the BoE’s target of 2% and will then start to decelerate gradually at around the end of the year (Chart 15). As the UK economy decelerates, domestic demand in particular, is expected to slow, and there is a limited possibility that import inflation will push the wage growth up, avoiding ‘homemade inflation’, which is where wages and inflation increase in a chain reaction.

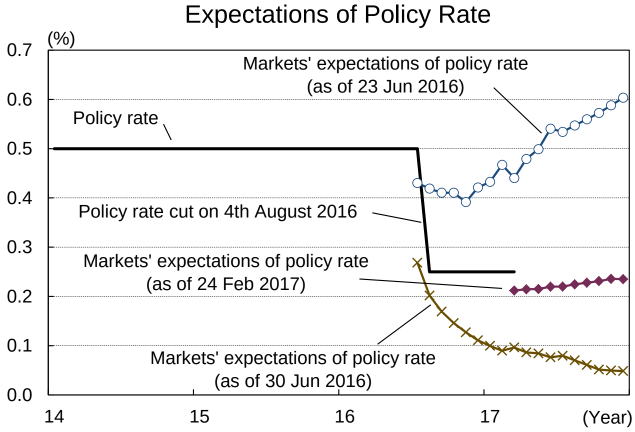
After deciding to lower its policy rate and expand the scale of its asset purchases in August last year, the Bank of England has not made any changes to its monetary policy. In 2017, the economy is expected to slow, but avoid significant deterioration, and it is thought that inflationary pressure from imports will gradually ease towards the end of the year. In light of this forecast, it seems that the BoE will continue to maintain its current monetary policy. Furthermore, even financial markets who forecasted a policy rate cut close to 0% immediately after the referendum last year now expect no change in the policy rate for the time being (Chart 16).

Chart 15: UK Consumer Price Index (CPI)



Source: UK Office for National Statistics, BTMU Economic Research Office

Chart 16: UK Policy Rate and Markets' Expectations of Policy Rate



Note: "Markets' expectations" is from the Overnight Index Swap (OIS)
Souce: Bloomberg, BTMU Economic Research Office

Europe Economic Outlook

	Real GDP (YoY, %)			HCPI/CPI (YoY, %)			Current Account Balance (USD, billions)		
	2015 Actual	2016 Actual	2017 Forecast	2015 Actual	2016 Actual	2017 Forecast	2015 Actual	2016 Actual	2017 Forecast
Eurozone	1.9	1.7	1.5	0.0	0.2	1.3	344.7	381.4	310.8
Germany	1.7	1.9	1.5	0.1	0.4	1.5	275.0	280.4	250.0
France	1.2	1.1	1.2	0.1	0.3	1.2	- 6.7	- 32.5	- 23.0
Italy	0.7	0.9	1.1	0.1	- 0.1	1.2	29.0	48.4	33.8
UK	2.2	1.8	1.1	0.0	0.6	2.2	- 122.6	- 127.6	- 101.5
Russia	- 2.3	- 0.2	0.8	15.6	7.1	5.7	69.0	22.2	49.0

(YoY, %)

	Eurozone			UK		
	2015 Actual	2016 Actual	2017 Forecast	2015 Actual	2016 Actual	2017 Forecast
Nominal GDP	3.2	2.6	2.8	2.8	3.6	3.9
Real GDP	2.0	1.7	1.5	2.2	1.8	1.1
Domestic demand	1.7	1.8	1.2	2.2	2.2	0.5
Net exports	0.3	- 0.1	0.2	0.0	- 0.4	0.6
Private consumption	1.8	1.8	1.1	2.4	3.0	1.8
Government expenditure	1.4	1.9	1.4	1.3	0.8	0.7
Gross fixed capital formation	3.2	2.4	1.2	3.4	0.5	- 2.8
Inventory	- 0.2	- 0.1	0.0	- 0.2	- 0.5	0.1
Exports	6.5	2.2	2.2	6.1	1.4	1.8
Imports	6.4	2.6	1.8	5.5	2.5	- 0.2

Note: 1. Eurozone is a total of 19 countries: Germany, France, Italy, Ireland, Estonia, Austria, the Netherlands, Cyprus, Greece, Spain, Slovakia, Slovenia, Finland, Belgium, Portugal, Malta, Luxembourg, Latvia and Lithuania
2. "HCPI/CPI" is standard inflation rate used by the EU
3. Eurozone "Nominal GDP", "Real GDP" and the breakdown for 2016 is not yet published, Economic Research Office data forecast is used.

Source: Eurostat, UK Office for National Statistics, BTMU Economic Research Office

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