The Outlook for European Economies

Uncertainty regarding Brexit lingers yet economic recovery continues unimpeded

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A member of MUFG, a global financial group

7 JUNE 2017
(ORIGINAL JAPANESE VERSION RELEASED ON 31 May 2017)

1. Eurozone

(1) Current Situation

The Eurozone economy continues to recover; real GDP growth remained resilient in Q1 at 0.5% quarter-on-quarter (QoQ) (Table 1). While the breakdown by expenditure of this figure has not yet been released, the business sector appears particularly robust as exports and construction sector output accelerated. Meanwhile, real retail sales growth slowed. A breakdown by country reveals that real GDP growth in France has slowed. Greece, where austerity measures continue, has contracted for the second consecutive quarter. However, growth in Germany, Spain and Portugal is accelerating. Looking at the breakdown of GDP figures in major countries which have already been released, in France, private consumption decelerated from 0.6% QoQ to 0.1% QoQ as the recovery of consumer sentiment faltered. Foreign demand also appears weak; exports decreased by 0.8% QoQ. On the other hand, in Germany, private consumption growth accelerated to 0.3% QoQ and gross fixed capital formation (such as equipment and construction investment) grew further by 1.7% QoQ. Exports also maintained strong growth for the second consecutive quarter: up by 1.3% QoQ.

There were concerns that Eurosceptic influences would rise at the Dutch general election in March and the French presidential election in May. However, the People’s Party for Freedom and Democracy (VVD) were victorious in the Netherlands and Emmanuel Macron was elected president of France, both of whom propose maintaining unity and deepening ties with the EU. The risk of a rise in Euroscepticism in continental Europe has been heightened by the UK’s decision to leave the EU in June last year. However, this risk has receded for now, avoiding turmoil in financial markets.

(2) Outlook

The domestic demand-led economic recovery in the Eurozone is forecast to continue. Private consumption remains resilient because the downward pressure on real purchasing power from increased inflation will soften as the effect of a recovery in resource prices wanes and labour market conditions improve. Growth of business investment also continues to rise on the back of higher capacity utilisation rates and increased business earnings. In Europe, there is still significant slack in the labour market due to the fact it suffered two crises over the last 10 years: the Global Financial Crisis and the European Debt Crisis. Furthermore, there is scope that domestic demand will return after it was pushed back during the period when the economy experienced a downturn. The Eurozone's real GDP growth rate is forecast at 1.5% year-on-year (YoY) for 2017 and 2018, continuing to grow at a slightly faster pace than the potential growth rate (Chart 1).

Turning to politics, elections are scheduled in France and Germany in June and September respectively. In France, La République En Marche!, led by Emmanuel Macron, are on track to win a majority of seats. In Germany, the Christian Democratic Union of Germany, chaired by Chancellor Angela Merkel, achieved victory in state elections, which were a bellwether ahead the parliamentary election, and maintained a strong support rate. It will be necessary to continue to monitor the spread of disillusion at existing politics and negative views towards the EU amongst citizens in Europe. However, if political parties who aim to maintain and deepen the EU union control the government and parliament in the two biggest European countries, Germany and France, then the risk of a negative impact on the real economy from uncertainty over political issues will recede further.

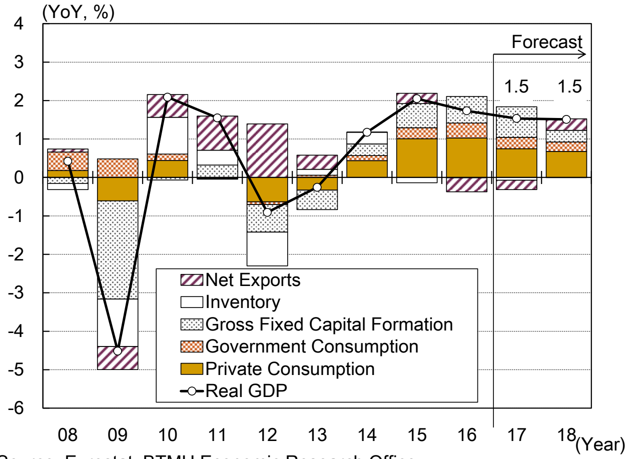
Table 1: Eurozone Real GDP

(QoQ, %)

	2015				2016				2017
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Eurozone	0.8	0.4	0.3	0.4	0.6	0.3	0.4	0.5	0.5
Germany	0.2	0.5	0.2	0.4	0.7	0.5	0.2	0.4	0.6
France	0.4	0.0	0.4	0.2	0.6	-0.1	0.2	0.5	0.4
Italy	0.3	0.4	0.1	0.2	0.4	0.1	0.3	0.2	0.2
Spain	1.0	0.8	0.9	0.8	0.8	0.8	0.7	0.7	0.8
Portugal	0.6	0.3	0.1	0.3	0.3	0.2	0.8	0.6	1.1
Greece	0.6	-0.1	-1.7	1.9	-0.7	0.3	0.6	-1.2	-0.1

Source: Eurostat, BTMU Economic Reserech Office

Chart 1: Eurozone Real GDP



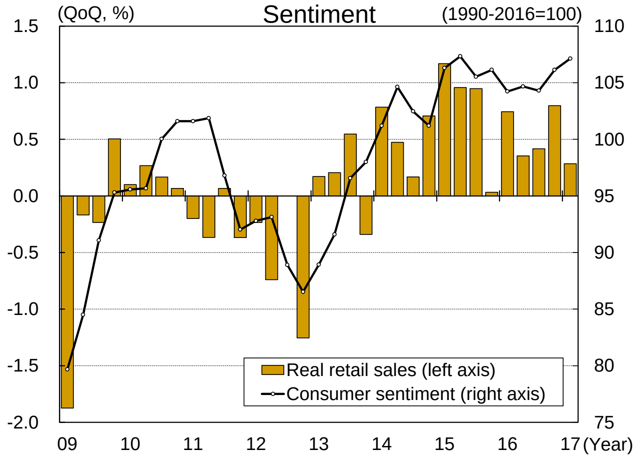
Source: Eurostat, BTMU Economic Research Office

(3) Key Points

① Private consumption maintains its resilience supported by improved labour market conditions

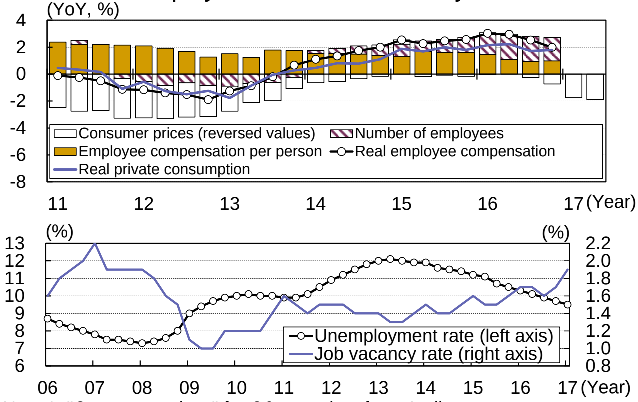
Real retail sales decelerated in Q1 from 0.8% QoQ to 0.3% QoQ (Chart 2), and although the breakdown of the headline GDP figure by expenditure has not yet been released, there is a high probability that private consumption has also slowed. Looking at real wages as a base for private consumption, we can confirm that, while the number of employees rose up until 2016, growth in employee compensation per person decelerated as wage growth slowed due to the fall in the inflation rate up until 2015 (Chart 3 upper). From the start of 2017, lower real purchasing power has weighed down private consumption. However, consumer sentiment is generally improving and, although wage growth is lagging behind the rise in inflation, it is accelerating, which is expected to support the growth of employee compensation per person. On top of this, it seems that the number of employees will continue to increase for a longer period of time owing to businesses' improved hiring appetite and the increased job vacancy rate. In light of these factors, it appears that private consumption will continue to maintain resilient growth.

Chart 2: Eurozone - Real Retail Sales and Consumer Sentiment



Source: Eurostat, European Commission, BTMU Economic Research Office

Chart 3: Eurozone - Real Employee Compensation and Unemployment and Job Vacancy Rates



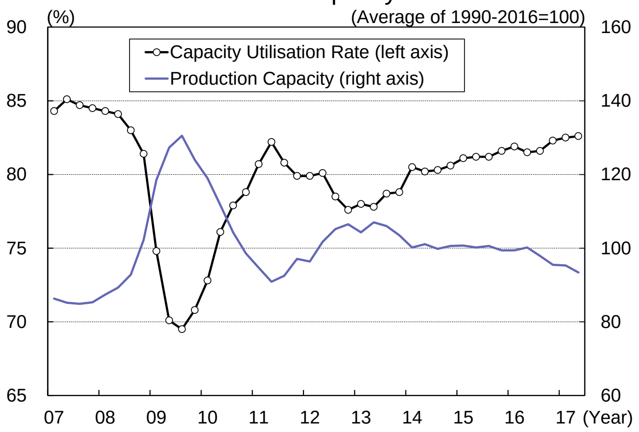
Note:1. "Consumer prices" for Q2 uses data from April
2. "Job vacancy rate" is job openings divided by the sum of job openings and number of employees

Source: Eurostat, European Commission, BTMU Economic Research Office

② Business investment will continue to recover gradually

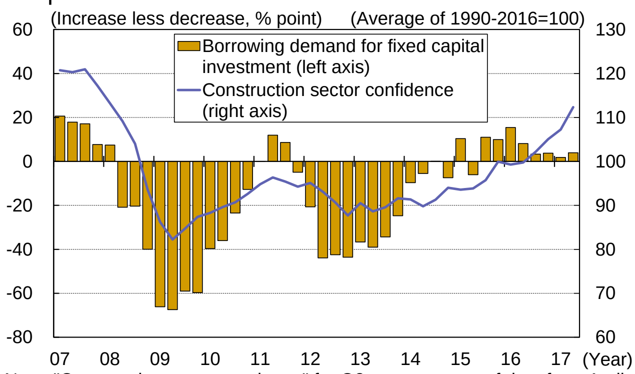
Although the data for business investment in Q1 has not yet been released, it is unlikely that business investment experienced a large rise as it did in Q4 last year (4.3% QoQ) when intellectual property investment significantly increased. However, it appears that real investment in particular maintained its upward trend as the construction sector's production continued at the same growth pace as the previous quarter: 0.8% QoQ. From now, it is likely that an increase in production capacity will be necessary due to a rise in the capacity utilisation rate. This means that business investment as a whole will probably maintain its upward growth trend (Chart 4). Moreover, borrowing demand related to businesses' gross fixed capital formation is on the rise, albeit gradually, as looser financial conditions continue. This, along with a clear improvement in construction sector sentiment, suggests that business investment will continue to recover (Chart 5).

Chart 4: Eurozone - Capacity Utilisation Rate and Production Capacity Index



Source: European Commission, BTMU Economic Research Office

Chart 5: Eurozone - Borrowing Demand for Fixed Capital Investment and Construction Sector Sentiment



Note: "Construction sector sentiment" for Q2 uses average of data from April and May

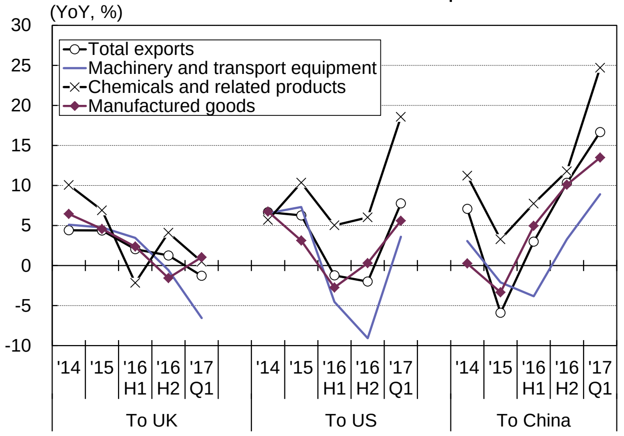
Source: European Commission, European Central Bank, BTMU Economic Research Office

③ Weaker exports to the UK will be supplemented with exports to the US

In Q1, real exports (on a customs basis) to the UK decelerated as the economy slows, yet exports to the US started to accelerate, especially machinery and transport equipment.

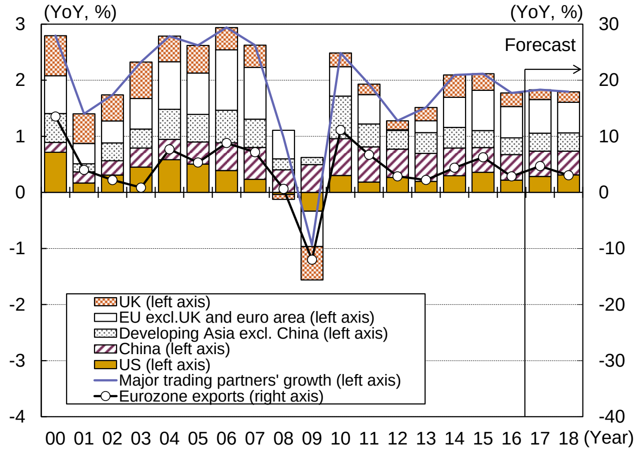
Recovery in exports to China, whose economy has begun to stabilise recently, has also supported overall export growth, which accelerated from 1.5% YoY in Q4 2016 to 3.4% YoY in Q1 2017 (Chart 6). This trend is forecast to continue in general in the coming months. Exports are expected to maintain their gradual upward trend due to a steady recovery of the global economy, particularly the US, despite weak exports to the UK as its economy slows (Chart 7).

Chart 6: Eurozone - Real Exports



Note: UK data for period "Q1 2017" does not include March.
Source: Eurostat, BTMU Economic Research Office

Chart 7: Eurozone - Exports



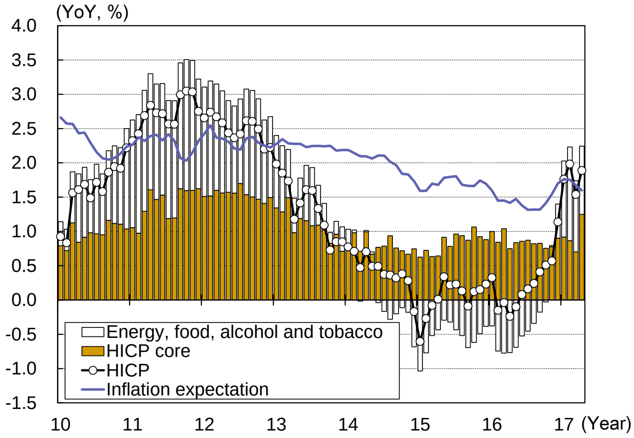
Source: Eurostat, IMF, BTMU Economic Research Office

(4) Monetary Policy

The overall Consumer Price Index (CPI), for which the European Central Bank (ECB) has set a target in order to maintain price stability, averaged 1.8% YoY in Q1 and accelerated to 1.9% YoY in April. However, it is probable that this is a temporary acceleration due to a recovery in energy prices in Q1 and the Easter holiday occurring later in the year compared with last year (April instead of March). It appears that core inflation is still following a weak trend (Chart 8). The ECB has also observed that the underlying upward pressure on prices is weak. In the Economic Bulletin published this month, they noted a considerable degree of labour market slack in southern European countries such as France and Italy along with slow wage growth. In fact, the unemployment rate is low and core inflation is relatively stable in Germany, whereas the unemployment rate in France and Italy remains elevated and core inflation is on a downward trend (Chart 9). Furthermore, while Spain's unemployment rate has started to fall after its worst period, it is still at a high level and its core inflation rate is significantly lower than the level it was at before the global financial crisis. Underlying inflationary pressure is forecast to rise gradually as the economy recovers, but it appears unlikely that it will reach the ECB's target of "inflation rates of below, but close to, 2% over the medium term" within this outlook period (until 2018). The possibility that the ECB will start to raise rates during this outlook period is low.

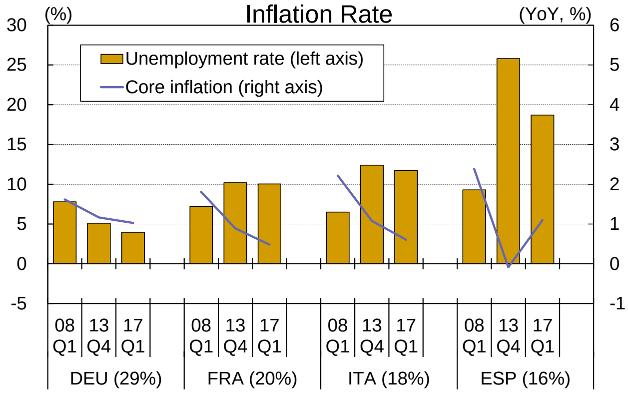
Speaking about the ECB's asset purchasing programme, Vítor Constâncio, Vice-President of the ECB, said that "we are explicitly committed to our policy until December, so of course this means automatically that in the fall we will have to decide what we will do next. By then we will have more information." In the current statement by the ECB, additional rate cuts and an expansion of the asset purchasing programme would be carried out if there was a downturn in the economy. Yves Mersch and Peter Praet, who are both Members of the Executive Board of the ECB, have recognised that this statement may need revision to bring it in line with the present situation. The expansion of the ECB's balance sheet due to the asset purchasing programme will probably end in 2018, and it is possible that the ECB will change its stance regarding monetary easing in accordance with the current point in the economy's recovery. However, it is more likely that the ECB does not plan to reduce its asset balance after the asset purchasing programme is concluded, which would mean that the ECB's position on monetary easing will continue unchanged.

Chart 8: Eurozone - Inflation



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

Chart 9: Eurozone - Unemployment Rate and Core Inflation Rate



Note: "2008 Q1" is before the Global Financial Crisis, "2013 Q4 is after the European Debt Crisis. Numbers in brackets denote the share of employees within the Eurozone.
Source: Eurostat, BTMU Economic Research Office

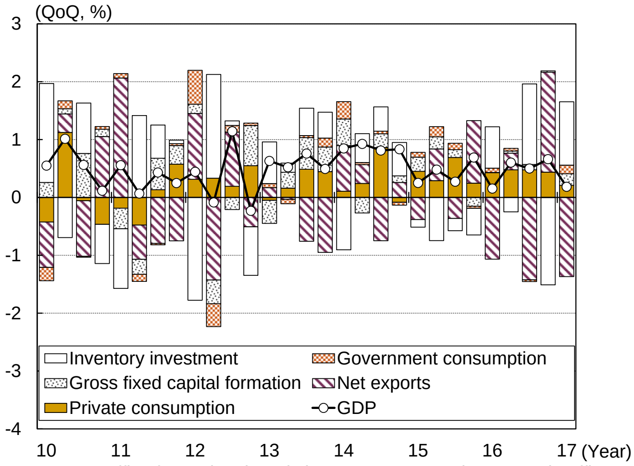
2. UK

(1) Current situation

In June last year, the UK voted to leave the EU which led to an increase in uncertainty surrounding the future of the UK economy, yet it has maintained resilient growth. However, even though a collapse of the UK economy has been avoided so far in 2017, there is still a visible downward trend. In Q1, GDP decelerated to 0.2% QoQ from 0.7% QoQ the previous quarter (Chart 10). Private consumption has slowed (Q4 2016: 0.7% QoQ → Q1 2017: 0.3% QoQ) due to rising inflation caused by pound depreciation. On top of this, growth of exports turned negative from 4.6% QoQ in Q4 2016 to -1.6% QoQ in Q1 2017, pushing down overall growth.

Turning to politics, Prime Minister Theresa May called a general election on 18th April which is scheduled to take place on 8th June. Theresa May previously announced that an election would not take place until the end of her term in 2020, but she decided to dissolve parliament saying, "it is necessary to secure the strong and stable leadership the country needs to see us through Brexit and beyond". Currently, the incumbent Conservative Party holds a narrow majority of 330 seats out of a total of 650 in the House of Commons, and there is a difference of opinion within the party regarding Brexit. Theresa May's aim is to strengthen her party's grip in parliament and her leadership within the party by increasing the number of Conservative Party seats (Table 2). However, there has been increased pressure from the largest opposition party, the Labour Party, since mid-May. If the Conservatives win fewer seats than expected, Theresa May's mandate which she would use to unify her party will be diminished.

Chart 10: UK Real GDP



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

Table 2: UK 2017 General Election Result - Expectation

Party	2015 General Election Result		2017General Election Result – Expectation		
	Percentage of votes	No. of seats won	Percentage of votes	No. of seats won	Change in no. of seats
The Conservative Party	37.8%	331	46.1%	373	+42
Labour Party	31.2%	232	33.2%	203	-29
Liberal Democrats	8.1%	8	7.9%	3	-5
UK Independence Party (UKIP)	12.9%	1	4.4%	0	-1
Green Party	3.8%	1	2.3%	1	No change
Scottish National Party (SNP)	4.9%	56	4.2%	49	-7
Plaid Cymru	0.6%	3	0.6%	3	No change
Other	0.7%	18	1.3%	18	No change

Note: Prediction according to Electoral Calculus on 30th May.
Source: Electoral Calculus, BTMU Economic Research Office

(2) Outlook

The future uncertainty surrounding Brexit negotiations is probably deeply rooted; however, the likelihood that the UK economy will deteriorate significantly due to its decision to leave the EU appears to have lessened. It is probable that the downward pressure on the economy will soften comparatively from the latter half of 2017 to mid-2018. This is because the rise in inflation brought about by pound depreciation as well as the shock to sentiment directly after the referendum will peak out.

Compared with 2014 and 2015, businesses' appetite for hiring and investment is still low, but it is recovering from a large fall during the latter half of 2016 (Chart 11). Growth in the number of employees is somewhat sluggish; however, it seems that the upward trend will continue and labour market conditions will remain generally positive. Furthermore, real business investment growth accelerated year-on-year for the first time in four quarters in Q1. Businesses curbed their investment before and after the referendum, but they now show signs of starting to increase their appetite again due to the fact that the UK economy avoided significant deterioration.

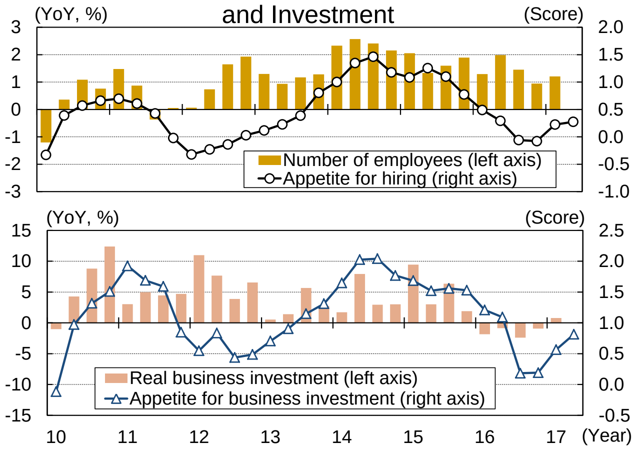
Looking at the growth of private consumption, it is likely that the pace will slowly recover when the rise in inflation peaks out, which is the reason for its current deceleration. However, it will be necessary to monitor the likelihood that growth of private consumption will not recover at the same pace as real disposable income. Despite the slowdown in the growth of real disposable income since the latter half of 2016, real private consumption maintained a high level of growth, resulting in a reduced rate of savings (Chart 12). Looking forward, if the rate of savings increases, a rebound in real private consumption will be suppressed.

Regarding fiscal policy, Theresa May will adopt policies which will not hurry the process of reducing the budget deficit, which means there is small possibility of downward pressure on the economy from austerity. In its manifesto, the Conservatives pledge to eliminate the deficit, which stood at 2.6% of GDP in 2016, by the mid-2020s.

Furthermore, foreign demand will underpin the UK economy due to resilient growth of developed economies, particularly the US and Eurozone, and the continued cyclical recovery of global trade.

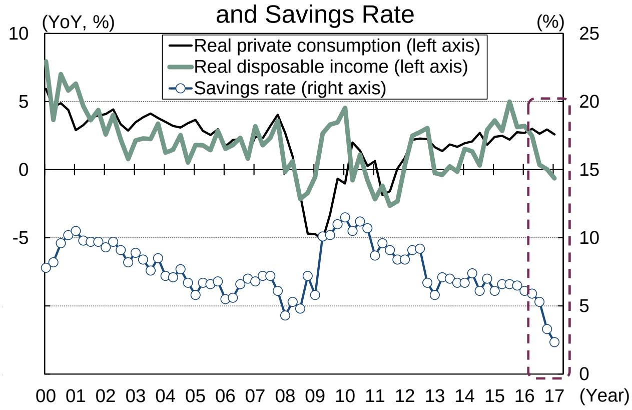
The economy as a whole is expected to remain sluggish for a while, but will recover slowly until the start of 2018. The real GDP growth rate is forecast at 1.3% YoY for 2017, and 1.4% YoY for 2018.

Chart 11: UK Businesses' Appetite for Hiring and Investment



Source: UK Office for National Statistics, Bank of England, BTMU Economic Research Office

Chart 12: UK Real Consumption, Disposable Income and Savings Rate



Note: Values for "real disposable income" and "savings rate" for 2017 Q1 are estimates produced by BTMU Economic Research Office

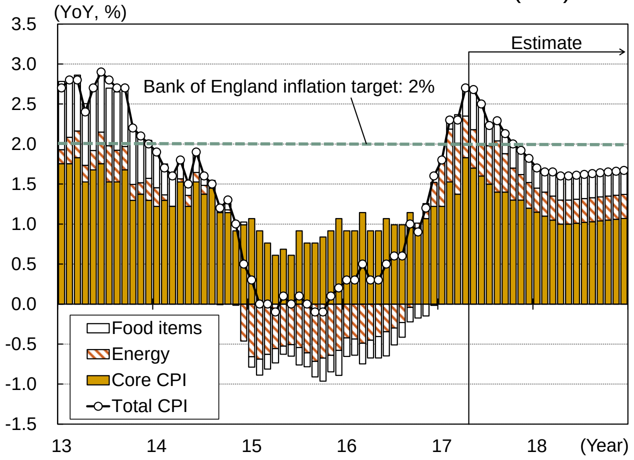
Source: UK Office for National Statistics, BTMU Economic Research Office

(3) Monetary policy

The inflation rate continues to rise; CPI rose to 2.7% YoY in April, the highest level since September 2013 (Chart 13). However, a sharp fall in the pound – the primary reason for import inflation – has peaked (Chart 14 upper). Currently, the pound is valued at around USD1.3, rebounding to the level last seen in September last year. Furthermore, upward pressure on oil prices continues to be limited, and it is likely there will be a lull in the rise of domestic energy prices in the coming months (Chart 14, lower). Inflation is expected to fall until the start of 2018, partly due to businesses maintaining their cautious approach to increasing wages.

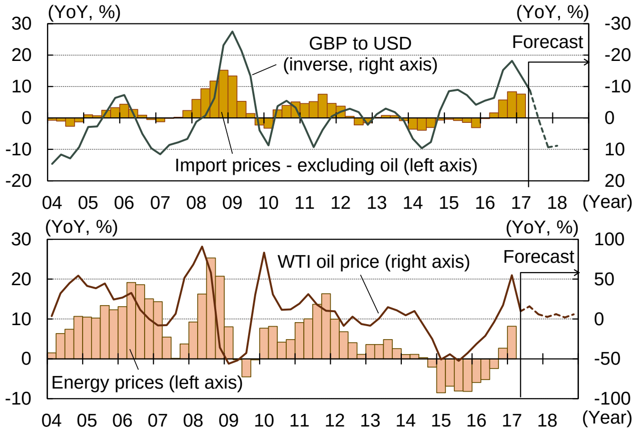
The Bank of England (BoE) has not changed their monetary policy since August last year, when they decided to cut interest rates and extend their asset purchasing programme. The downside risks to the economy are expected to fade and the inflation rate will dip below the BoE's target of 2% YoY in the latter half of 2017 and into 2018. As such, it is likely that there will be no changes made to monetary policy.

Chart 13: UK Consumer Price Index (CPI)



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

Chart 14: UK Import and Energy Prices



Note: "GBP to USD" uses the MUFG Global Market Unit's forecast, "WTI oil price" uses the BTMU Economic Research Office's forecast.
Source: UK Office for National Statistics, Bloomberg, BTMU Economic Research Office

3. Russia

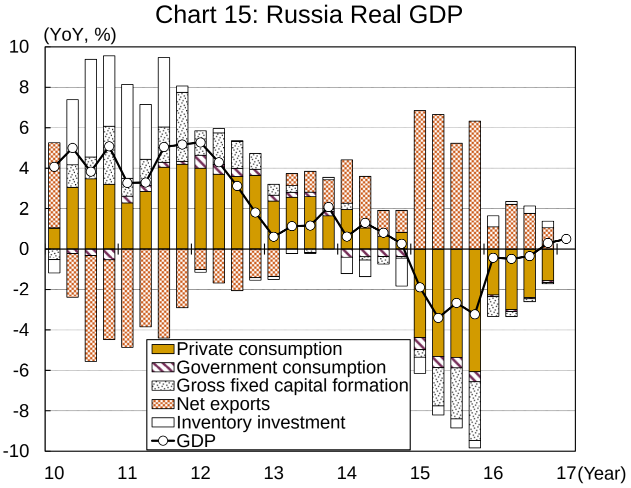
(1) Current Situation

At the end of last year, Russia pulled out of its recession and entered a phase of recovery. In Q4 2016, the real GDP growth rate increased by 0.3% YoY and entered positive territory for the first time in two years. It continued to accelerate in Q1 this year: 0.5% YoY (Chart 15). Moreover, the composite Purchasing Managers' Index (PMI) rose to 58.3 in January, the highest level since 2008. It then fell to 55.3 in April but remains well above 50, the level which marks the boundary between expansion and contraction of business activities. Looking at households, sentiment has improved and consumption has bottomed out and appears to be following a trend of recovery.

Inflationary pressure on imports has fallen due to stabilisation of the rouble. Along with this, an improvement in the oil and gas market, which comprises 70% of Russian exports, has led to a recovery of Russia's economy. Looking at prices in particular, the sharp growth of food prices has slowed owing to an abundant grain harvest, and CPI fell to 4.1% YoY in April, the lowest level since 2012 (Chart 16 upper).

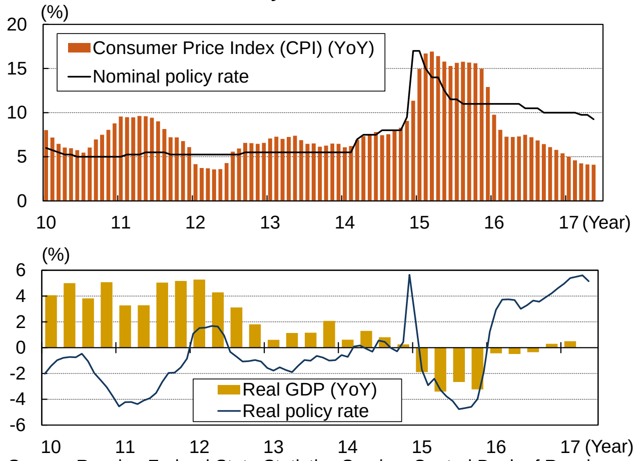
The Central Bank of Russia (CBR) is cutting the policy rate gradually, taking into account the fact that the inflation rate is drawing closer to their target of 4% YoY. At the most recent Board of Directors meeting on monetary policy issues in April, members decided to continue reducing the policy rate as they did in their previous meeting in March, cutting the policy rate to 9.25%. Banks' are easing their lending standards and increasing their number of new loans, which will be a factor in supporting the recovery of the Russian economy.

Chart 15: Russia Real GDP



Source: Russian Federal State Statistics Service, BTMU Economic Research Office

Chart 16: Russia - Policy Rate, Inflation Rate, Real GDP



Source: Russian Federal State Statistics Service, Central Bank of Russia, BTMU Economic Research Office

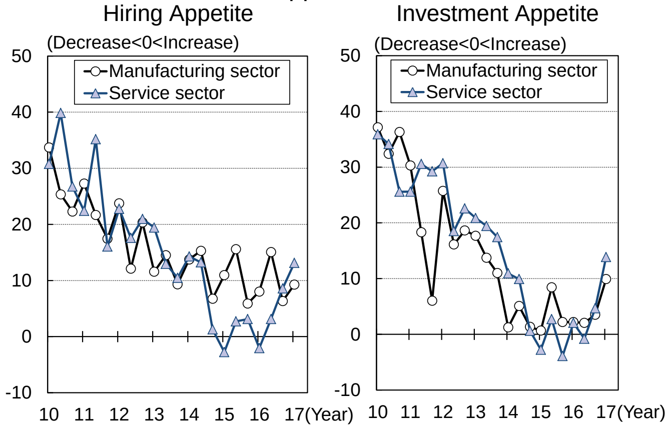
(2) Outlook

The Russian economy will follow a trend of gradual recovery into the future. Currently, businesses' appetite for hiring and investment appears to be increasing and improvements in labour market conditions in the future are expected to push up private consumption and increase business investment (Chart 17). In addition, further rate cuts will contribute to the economic recovery. At present, the real policy rate (nominal policy rate less CPI growth rate) is just above 5%, greatly exceeding the average level in the past, and is at a high level when compared with the real GDP growth rate (Chart 16, lower). While the CBR is monitoring the risk that hasty rate cuts will increase inflation expectations, they are forecast to cut rates to the current real equilibrium rate of between 2.5% and 3.0% at the very least.

It is clear that there are suitable sources of continued support for the recovery of the Russian economy, but the rise of energy prices will remain at a gradual pace into next year and it is unlikely that economic growth will accelerate swiftly. BTMU Economic Research Office forecasts WTI oil prices will average USD51 in 2017 and USD54 in 2018, remaining just above USD50. Russia's real GDP growth rate is closely related to the growth of oil prices, which will experience comparatively high growth of 18.3% YoY in 2017, but then slow to 5.0% YoY in 2018 (Chart 18).

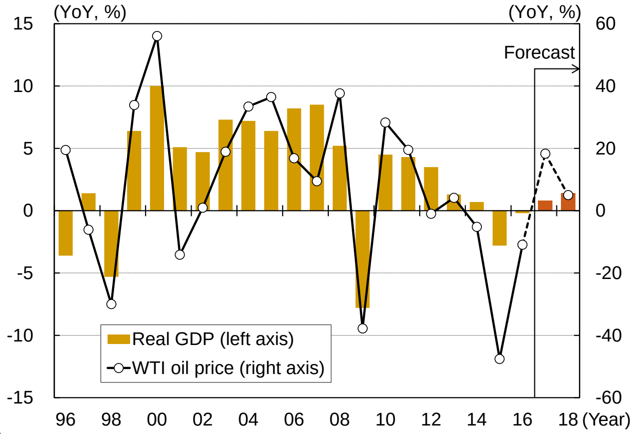
The Russian government will maintain their fiscal austerity policy as revenue from energy – comprising approximately 40% of government revenue – is not forecast to recover significantly. According to the federal budget, annual government expenditure is expected to fall by 1.1% YoY in 2017 and 1.2% YoY in 2018 (on a nominal basis). There is a strong possibility that this will be a primary factor in inhibiting economic growth. The real GDP growth rate will enter positive territory for the first time in three years in 2017, accelerating 0.8% YoY, and will maintain positive growth of 1.2% YoY in 2018. Russia's economic recovery is expected to remain gradual.

Chart 17: Russian Businesses' Hiring and Investment Appetite



Source: Markit, BTMU Economic Research Office

Chart 18: Russia Real GDP and Oil Prices



Source: Russian Federal State Statistics Service, Bloomberg, BTMU Economic Research Office

The Russian presidential election is scheduled to take place in March 2018. While it is clear that President Vladimir Putin will be re-elected, the amount of votes he can win will be scrutinised as a vote of confidence in his leadership. At the previous presidential election in 2012, oil prices were at a high level (around USD100 per barrel) and the government could use the abundant energy-related revenues to increase public spending ahead of the election. However, this time the scope for increasing public spending in this way will be limited. Although the rate cuts by the CBR appear to have had a definite impact on the election campaign, support for the campaign from fiscal and monetary policies in 2018 will remain on a smaller scale compared with the previous election in 2012.

There are concerns surrounding the risk that President Putin’s assertive foreign policies could have an impact on Russia’s economy. Since Russia annexed Crimea, President Putin has stepped up his plans to increase his approval rating through foreign policies such as taking a confrontational stance against Europe and the US and engaging in the Syrian civil war. It will be necessary to monitor the risk that hard-line foreign policies will increase geopolitical tensions and disrupt foreign and domestic financial markets and economies.

Europe Economic Outlook

	Real GDP (YoY, %)			HCPI/CPI (YoY, %)			Current Account Balance (USD, billions)		
	2016 Actual	2017 Forecast	2018 Forecast	2016 Actual	2017 Forecast	2018 Forecast	2016 Actual	2017 Forecast	2018 Forecast
Eurozone	1.8	1.5	1.5	0.2	1.6	1.5	397.8	307.8	256.5
Germany	1.9	1.5	1.6	0.4	1.6	1.7	289.2	240.6	205.1
France	1.2	1.2	1.1	0.3	1.5	1.4	-22.7	-38.0	-32.8
Italy	0.9	0.8	1.0	-0.1	1.5	1.4	47.7	35.2	34.2
UK	1.8	1.3	1.4	0.7	2.2	1.6	-114.5	-69.1	-68.8
Russia	-0.2	0.8	1.2	7.1	4.3	4.2	25.0	31.3	25.3

(YoY, %)

	Eurozone			UK		
	2016 Actual	2017 Forecast	2018 Forecast	2016 Actual	2017 Forecast	2018 Forecast
Nominal GDP	2.7	3.0	2.9	3.6	3.9	3.8
Real GDP	1.8	1.5	1.5	1.8	1.3	1.4
Domestic demand	2.1	1.7	1.2	2.2	1.9	1.2
Net exports	-0.3	-0.2	0.3	-0.4	-0.6	0.2
Private consumption	1.9	1.4	1.2	2.8	1.7	1.3
Government expenditure	1.8	1.4	1.2	0.8	1.0	0.8
Gross fixed capital formation	3.5	3.9	1.4	0.5	1.3	0.7
Inventory	0.0	-0.1	0.0	-0.1	0.1	0.1
Exports	2.9	4.7	3.1	1.8	1.5	1.8
Imports	4.0	5.6	2.6	2.8	3.2	0.9

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

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