# The Outlook for European Economies

## *Economy expected to remain robust despite heightening risk of Brexit standstill*

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## 1. Eurozone

### (1) Current Situation

The Eurozone maintained strong growth of 0.6% quarter-on-quarter (QoQ) in Q2 (Table 1). Though the breakdown by expenditure of this figure is yet to be published, we can see that domestic demand was stable due to increased real retail sales and construction sector production. The first thing that stands out from the country breakdown is Spain's acceleration of 0.7% QoQ. Domestic demand was healthy, and private consumption experienced a significant increase of 0.7% QoQ against a backdrop of improved employment conditions. In addition, investment in construction grew by 1.1% QoQ, following an upturn in the financing environment. Foreign demand was affected by the port strike, which started at the beginning of June, contributing to a rise of 0.1% QoQ. Furthermore, France and Italy, which had seen a slow pace of recovery, retained the same level of growth as the previous quarter. Germany's high GDP growth continued at 0.6% QoQ, domestic demand continued to be buoyant, with private consumption up 0.8% QoQ, and gross fixed capital formation up 1.0%.

### (2) Outlook

The domestic demand-led economic recovery in the Eurozone is forecast to continue. Strong growth of private consumption is expected, with easing of downward pressure on real incomes from the cycle of price acceleration, and continued improvement of employment and income conditions. Both exports and investment in equipment have maintained an upward trend, based on the recovery of foreign economies and corporate earnings. From what we have seen from two previous crises, the Global Financial Crisis and European Debt Crisis, there is still room for the possibility that pent up demand (demand carried forward to the future from a time of economic downturn) and expansion of labour supply might become evident. The real GDP growth rate is forecast at 1.8% year-on-year (YoY) for 2017, and 1.6% YoY for 2018 (Chart 1). The pace of recovery is influenced in part by the fact that the gap between supply and demand is shrinking, and exceeds the potential growth rate, which is just over 1.0% YoY.

Turning to politics, in the French election in June, centrist La Republique En Marche!, led by Emmanuel Macron gained a considerable majority of seats, but parties which claim to cater to public demand, such as the Front National, were unable to extend their influence despite the withdrawal of established parties. The Macron administration assumes the aim of deepening EU integration by advancing deficit reduction and labour market reforms in France. Ahead of Germany's planned election in September, the reigning Christian Democratic Union continues to hold the advantage, and it looks increasingly likely that Chancellor Merkel will be elected for a fourth term. There remain issues in need of monitoring, such as Italy's strongly populist Five Star Movement's approval rating matching that of the ruling Democratic Party, and Emmanuel Macron's current sudden drop in approval ratings, yet the risk of a negative impact on the real economy from a lack of political clarity has shrank considerably since the start of the year.

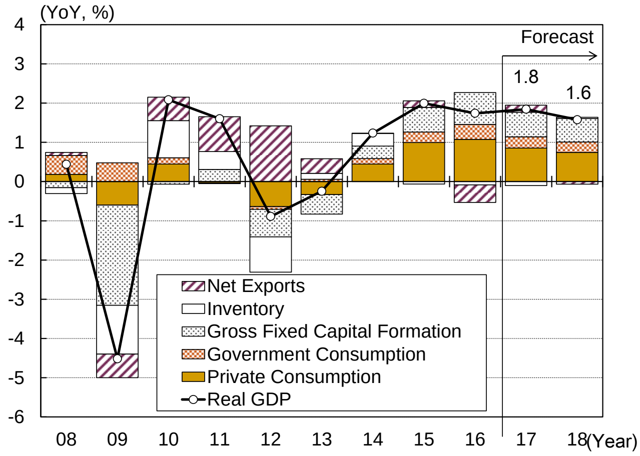
Table 1: Eurozone Real GDP

(QoQ, %)

| | 2015 | | 2016 | | | | 2017 | |
|---|---|---|---|---|---|---|---|---|
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 |
| Eurozone | 0.4 | 0.4 | 0.5 | 0.3 | 0.4 | 0.6 | 0.5 | 0.6 |
| Germany | 0.3 | 0.4 | 0.6 | 0.5 | 0.3 | 0.4 | 0.7 | 0.6 |
| France | 0.4 | 0.3 | 0.6 | -0.1 | 0.2 | 0.5 | 0.5 | 0.5 |
| Italy | 0.1 | 0.2 | 0.3 | 0.1 | 0.3 | 0.4 | 0.4 | 0.4 |
| Spain | 0.9 | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 | 0.8 | 0.9 |
| Portugal | 0.1 | 0.3 | 0.2 | 0.2 | 0.9 | 0.7 | 1.0 | 0.3 |
| Greece | -1.7 | 2.0 | -1.0 | 0.4 | 0.7 | -1.1 | 0.4 | - |

Source: Eurostat, BTMU Economic Research Office

Chart 1: Eurozone Real GDP




Source: Eurostat, BTMU Economic Research Office

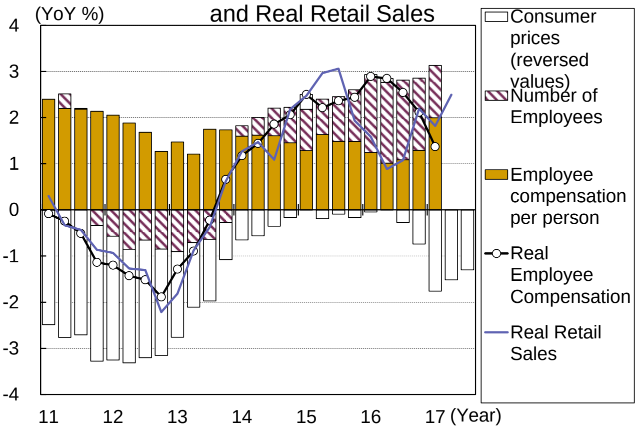
### (3) Key Points

① Private consumption predicted to maintain growth

There is a strong possibility that the pace of increase of private consumption has accelerated based on GDP data; real retail sales for Q2 are up 2.5% YoY, accelerated from the Q1 figure (1.8% YoY), supported by improvement in employment and income conditions (Chart 2). Looking at real wages as a base for private consumption, though real wages experienced considerable downward pressure in Q1 due to a rise in inflation, the acceleration of nominal employee compensation per person is ongoing. Looking at employment conditions, unemployment rates dropped to 9.2% in Q2 and the number of employees grew by 1.0% YoY, maintaining very swift growth, particularly in the manufacturing and construction industries, which continue to see improvement in production (Chart 3). In countries where the unemployment rate is comparatively high, such as Italy (Q2: 11.2%) and Spain (Q2: 17.3%), factors such as increased appetite for hiring among employers, and the rise of vacancy rates in the Eurozone as a whole, suggest that there remains substantial room for improvement in the labour market in the coming years.

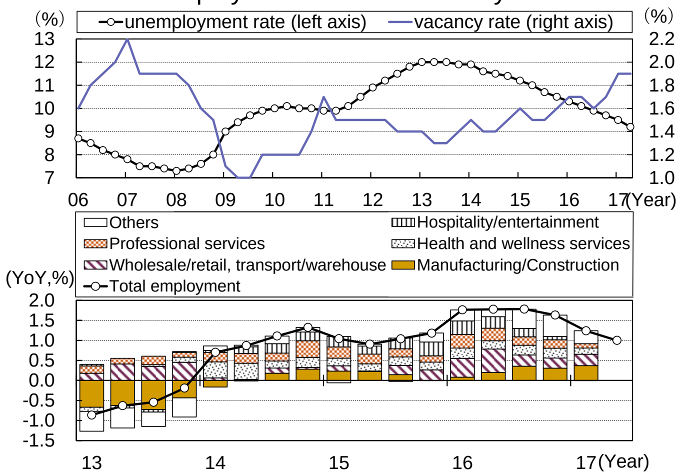
There is a high probability that robust consumer spending will continue, in light of factors such as the continued improvement of consumer sentiment, an easing of downward pressure on real wages due to price acceleration from its peak in Q1, and a gentle pick up in the speed of wage increases brought on by labour supply and demand tightening.

Chart 2: Eurozone- Real Employee Compensation and Real Retail Sales




Note: Consumer prices for Q3 uses data from July.
Source: Eurostat, BTMU Economic Research Office

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

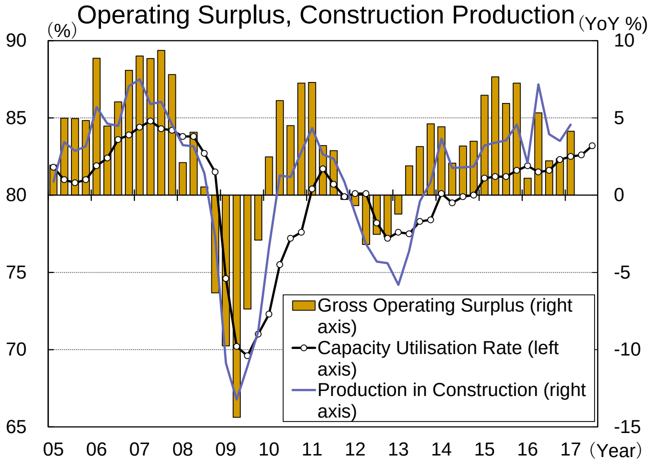



Note 1. "Job vacancy rate" = job openings ÷ (total job openings + total employees)
Note 2. Total employment for April-June is calculated using unemployment figures
Source: Eurostat, European Commission, BTMU Economic Research Office

## ② Continued recovery of capital expenditure

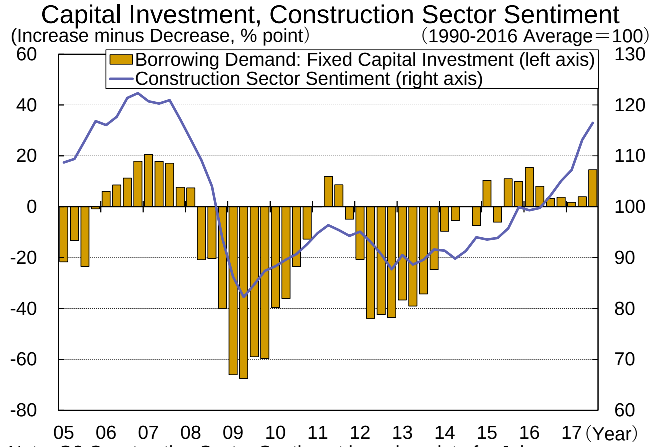
Capital expenditure is also expected to maintain growing upward momentum in Q2, particularly in construction, machinery, and equipment. In Q2, production in construction is at 1.1% QoQ, accelerating from the previous quarter (0.8% QoQ), and the capacity utilisation rate also increased to 83.2%, moving above its pre-financial crisis (2001-2007) average of 82.2% (Chart 4). In addition to the continuing improvement of corporate earnings, borrowing demand for fixed capital investment is rising, backed by good borrowing conditions such as low interest rates (Chart 5). Moreover, the improvement of construction sector sentiment is accelerating based on order increases, particularly in major powers such as Germany and Spain. Over the coming years, these conditions are predicted to remain generally unchanged and, consequently, capital expenditure is expected to continue to recover.

Chart 4: Eurozone- Capacity Utilisation Rate, Gross Operating Surplus, Construction Production




Source: Eurostat, European Commission, BTMU Economic Research Office

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




Note: Q3 Construction Sector Sentiment based on data for July
Source: Eurostat, ECB Statistical Data, BTMU Economic Research Office

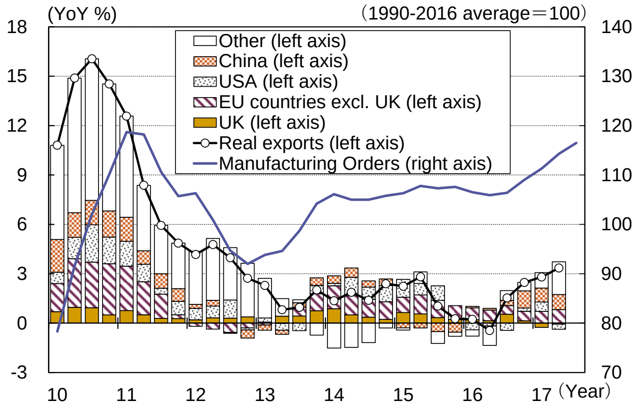
## ③ Robust exports and the underpinning of public spending

Though Q2 saw minor decreases in exports to countries such as the UK and USA, exports to

China and Russia (among others) provided traction, resulting in acceleration overall on a year-on-year basis (Chart 6). There is a strong possibility that exports will remain robust in the coming years, based on the recovery of foreign economies following the increased upwards momentum of manufacturing export orders.

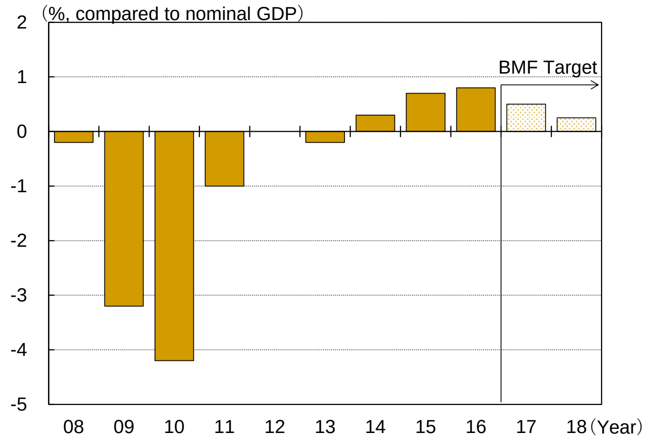
In terms of fiscal policy, Germany, the one-time lead proponent of fiscal restraint, is expected to see a change from last year's 6.2 billion euro budget federal government surplus, to a predicted 7 billion euro deficit for 2017, due to expenditure increases in social security and national defence. This is expected to cause a year-on-year reduction of the general government surplus (Chart 7). France is aiming to control its 2017 fiscal deficit within a limit of 3% of nominal GDP, a reduction from last year's 3.2%. However, looking at the situation until now, there is a strong probability that the deficit will be similar to last year due to the acceleration of costs for emergency measures. It can be said to be currently reaching a turning point from the negative impacts of post-financial crisis austerity measures.

Chart 6: Eurozone -Real Exports and Manufacturing Orders




Note 1: Q2 Real exports use average for April-May.
Note 2: Q3 Manufacturing Orders uses data from July.
Source: Eurostat, European Commission, BTMU Economic Research Office

Chart 7: Germany - Fiscal Balance

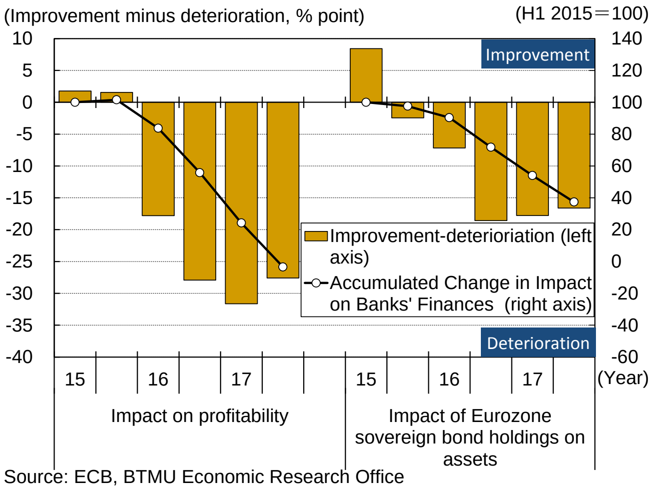



Source: German Federal Ministry of Finance (BMF)
BTMU Economic Research Office

**(4) Monetary Policy**

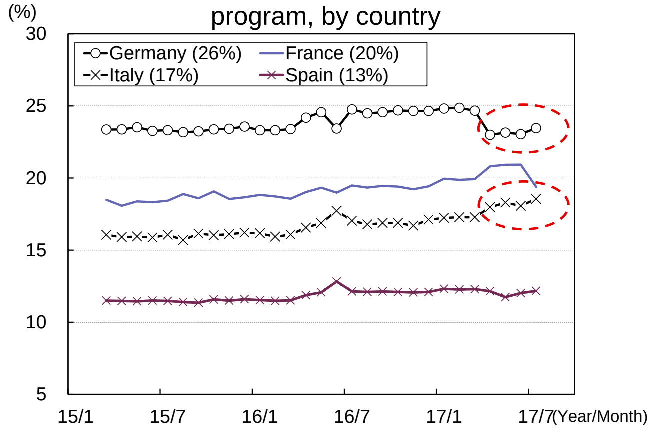
According to the European Central Bank (ECB) euro area bank lending survey, the penetration of the effects of monetary easing are beginning to become clear, with more answers that credit standards have "eased" rather than "tightened" quarter-on-quarter, due to low interest rates. At the same time, it is important to take note of the fact that more respondents said the Asset Purchase Program (APP) has led to a "deterioration" of banks' financial situations than those who thought it had "improved" over the past six months through lowering interest rates (Chart 8). Following an extended period of low interest rates, the side effects of large scale quantitative easing have surfaced, such as the shrinking trend in Banks' profitability in Eurozone countries. Additionally, there has been a shortage of eligible bonds due to the extension of the public sector purchase program, which forms part of APP. This fact fast shows signs of becoming a technical obstacle to maintaining APP at its current scale. In principle, the ECB uses the capital key to calculate bond purchases, which should, as a rule, be based on the rate of capital contribution to the ECB. However, while Germany has a capital contribution rate of 26%, the purchase of German bonds has dropped to 23%, Italy has a capital contribution rate of 17% and purchases have risen to 19% (Chart 9). The ECB is working under the understanding that "deflationary forces have been replaced by reflationary ones.", and in this context it is highly probable that the ECB will gradually reduce the scale of APP from early 2018, as a reaction to recent economic recovery. However, consumer price inflation at 1.3% YoY in July was considerably below the ECB's target of "just below 2% YoY in the medium-term". Looking at the core states, Germany accelerated to 1.5% YoY, higher than the pre-financial crisis (2001-2007) average of 1.1% YoY. However, other Eurozone countries continue to lack acceleration, averaging 0.6% YoY, which is below their pre-financial crisis average (2.1% YoY). Due to these factors, the ECB is maintaining a cautious stance on interest rate increases out of consideration for countries where economic recovery is relatively slow.

Chart 8: Impact of APP on Banks' Financial Situation




Source: ECB, BTMU Economic Research Office

Chart 9: Capital contribution to public sector purchase program, by country




Note: Figures in brackets indicate ECB's capital key
Source: ECB, BTMU Economic Research Office

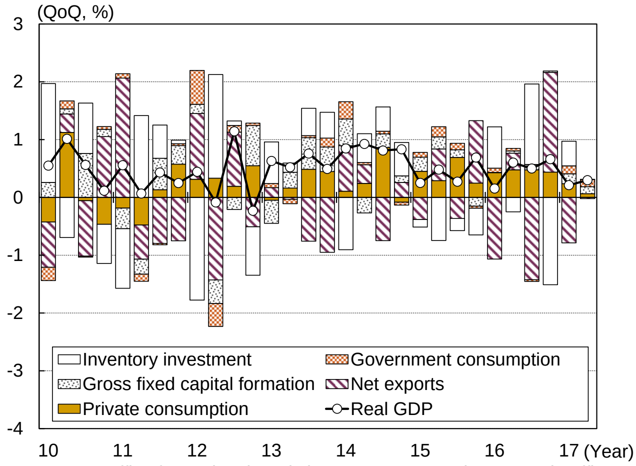
## 2. UK

### (1) Current situation

The UK economy has seen sluggish growth since early 2017. Real GDP growth was up 0.3% YoY in Q2 from 0.2% YoY in Q1, a small increase compared to 0.6%, which was recorded in the latter half of 2016 (Chart 10). The reason for this is downward pressure on private consumption caused by accelerating inflation resulting from the weak pound. In addition to this, corporate capital expenditure has remained at the same level as Q1, and residential investment has declined. On the other hand, exports have turned to growth, decreasing the negative contribution of net exports to GDP growth.

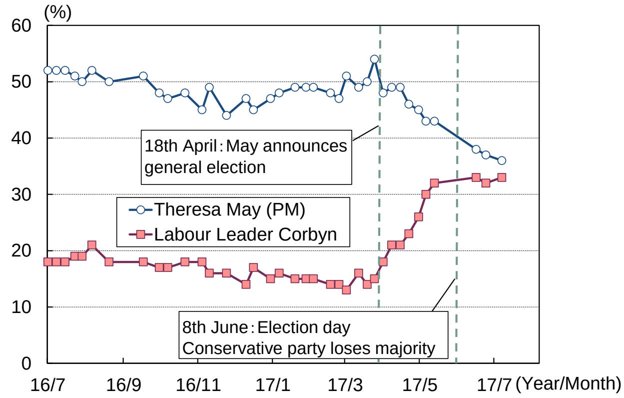
From a political point of view, the ruling conservative party lost seats in the election on 8th June, and fell below the numbers needed for a commons majority. Though the conservative party regained a majority through a deal with the conservative Northern Irish Democratic Unionist Party, approval ratings for the prime minister, Theresa May, continue to fall, and uncertainty about the political situation is on the rise (Chart 11). If political confusion escalates further, it is likely to become important to take precautions against risks such as a downturn in sentiment, and the delay of Brexit negotiations.

Chart 10: UK Real GDP




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

Chart 11: Approval ratings for PM May and Labour Leader Corbyn




Note: Responses to "who do you think would make the best prime minister?

Source: YouGov Survey, BTMU Economic Research Office

**(2) Outlook**

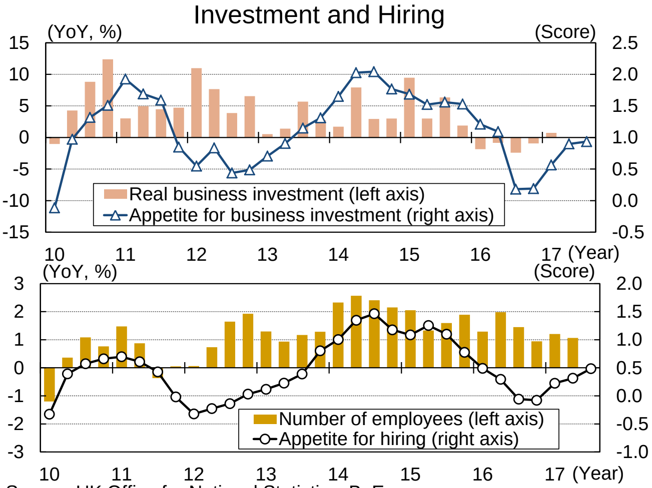
With deep rooted uncertainty over the future of Brexit, there is a strong possibility that the UK's real GDP growth rate will fall considerably below the 2-2.5% annual rate that it had been cruising at previously. However, looking at forecasts for 2017 and 2018, both show sluggish growth, but we will see relative stabilisation of the economy in 2018. This is expected to come from the easing of downward pressure on the economy, which has been influenced by factors such as the sudden drop in the value of the pound, and substantial deterioration in sentiment immediately after the referendum.

From the point of view of the corporate sector, capital expenditure remains weak. However, the manufacturing sector, with its robust exports, has provided traction for investment appetite, which has been on an improving track since the beginning of this year (Chart 12, upper). Cut backs to investment had followed the drop in sentiment in the latter half of last year. However, capital expenditure is expected to return to moderate growth in the near future, due to a reduction in these cut backs. In terms of exports, the Eurozone and USA, which are key export markets for the UK, have increased their orders following strong economic growth. Exports are expected to remain robust. July's Manufacturing Purchase Managers Index (PMI) export order figures rose to their highest level since 2011.

In the household sector, employment figures maintained robust growth, and Q2 unemployment figures were at their lowest level since 1975 at 4.4% (Chart 13). Labour conditions are expected to stay healthy due to an improvement in companies' appetite for hiring (Chart 12, lower). On the other hand, the wage growth rate of around 2% YoY remains below the rate of inflation. According to the Bank of England (BoE) business conditions survey, companies expect wage growth for this year to be in the range of 2-2.5% YoY, giving a high probability of continued low-level growth in wages of around 2%. In future, the inflation rate is expected to fall due to the waning influence of the weak pound, which will push up real wages. An increase in employment coupled with improvement in real wages is expected to continue into next year, contributing to an improvement in private consumption. Q1's saving rate at 1.7%, hit its lowest levels since records began in 1963. At present, there is a possibility that consumption levels are becoming somewhat excessive compared to wages, and it is important to monitor the risk of consumption being controlled as a reaction to this.

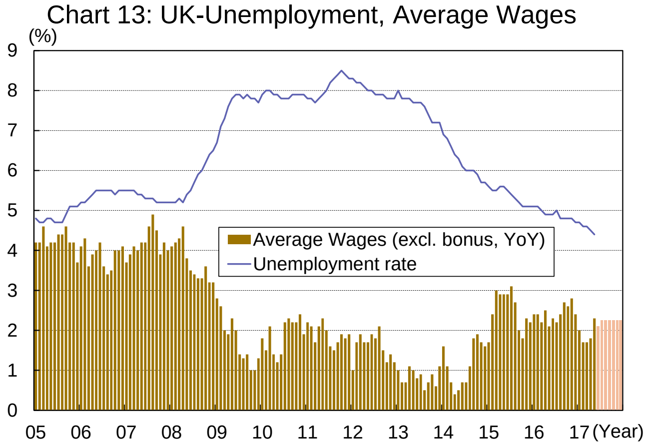
Regarding the real GDP growth rate, 2018 is predicted to see a small improvement at 1.5% YoY, after 2017 saw its lowest level of increase since 2012 at 1.4% YoY.

Chart 12: UK Businesses' Appetite for Investment and Hiring




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

Chart 13: UK-Unemployment, Average Wages

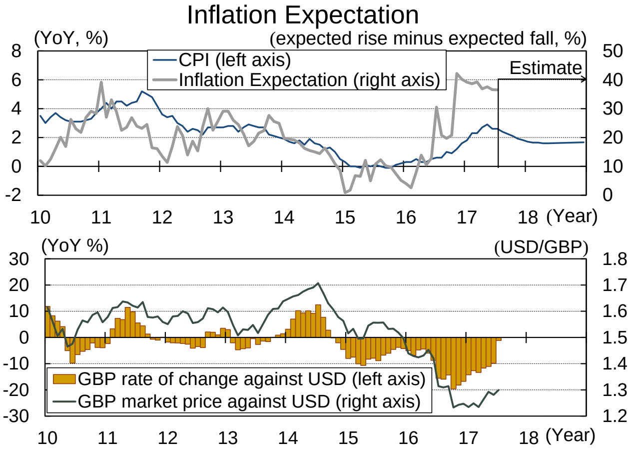



Note: Figures for average wages post-2017 July from BoE Business Survey
Source: UK Office for Natational Statistics, BoE
BTMU Economic Research Office

**(3) Monetary policy**

After rising to 2.9% YoY in May, the highest since June 2013, CPI slowed to 2.6% YoY in June and July. Having gone through a cycle of price increasing factors, inflation is showing signs of beginning to level off (Chart 14 upper). The latter half of last year saw a rise in import prices due to a particularly weak pound causing an acceleration of CPI. However, the value of the pound has stopped dropping from the start of this year, and the pressure of import inflation is easing (Chart 14, lower). Oil prices have also levelled off since the beginning of this year, and subdued increases are predicted to develop the coming years. Despite the low unemployment rate, there is limited inflationary pressure from wage factors due to employers continued adoption of a cautious stance towards an increase in wages. Consumer inflation expectations are also levelling off, and the inflation rate is expected to continue on a downward trend until early next year. The BOE raised its sense of caution around inflation after inflation continued on a rising trend until May. Some members of the Monetary Policy Committee (MPC) voted to raise interest rates, and BOE governor Mark Carney is showing signs that he is considering raising interest rates (Table 2). However, we believe that the future slowdown in inflation is likely to cause a softening in the BOE’s cautious tone on inflation. By the start of next year, consumer price inflation is forecast to fall below the BoE target of 2% YoY, and current monetary policy is expected to be maintained for the time being.

Chart 14：UK Consumer Price Index（CPI), Inflation Expectation




Source: UK Office for National Statistics, European Commission, Macrobond BTMU Economic Research Office

Table 2: BoE Monetary Policy Committee comments on interest rates

| | |
|---|---|
| 15-Jun | 3 of 8 members (Forbes, McCafferty, Saunders) of MPC vote for rate increase, though policy rate left unchanged |
| 16-Jun | Kristin Forbes indicates possibility that inflation due to the weak pound may not be temporary |
| 28-Jun | Carney announces MPC will consider raising rates within the following few months. |
| 29-Jun | Andy Haldane “we need to look seriously at the possibility of raising interest rates” |
| 4-Jul | Michael Saunders “Prepare for higher interest rates” |
| 12-Jul | McCafferty urges early unwinding of quantitative easing |
| 3-Aug | 2 members (McCafferty, Saunders) of MPC vote for rate increase, though policy rate left unchanged (Forbes left committee at the end of July). Possibility raised that rates would be increased within 1 year. |
| 4-Aug | Deputy Governor Ben Broadbent hints at possibility of small rate rise |

Source: Various sources, BoE, BTMU Economic Research Office

# 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 | 1.7 | 1.8 | 1.6 | 0.2 | 1.5 | 1.5 | 412.5 | 368.1 | 343.8 |
| Germany | 1.9 | 1.9 | 1.8 | 0.4 | 1.6 | 1.8 | 290.3 | 285.7 | 292.0 |
| France | 1.2 | 1.4 | 1.2 | 0.3 | 1.2 | 1.3 | -21.0 | -33.6 | -32.1 |
| Italy | 0.9 | 1.2 | 1.1 | -0.1 | 1.4 | 1.4 | 47.3 | 46.0 | 44.6 |
| UK | 1.8 | 1.4 | 1.5 | 0.7 | 2.3 | 1.6 | -114.5 | -75.5 | -70.0 |
| 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 | 2.6 | 3.2 | 2.9 | 3.6 | 3.7 | 3.4 |
| Real GDP | 1.7 | 1.8 | 1.6 | 1.8 | 1.4 | 1.5 |
| Domestic demand | 2.2 | 1.6 | 1.6 | 2.2 | 1.5 | 1.3 |
| Net exports | -0.4 | 0.2 | -0.1 | -0.4 | -0.1 | 0.2 |
| Private consumption | 2.0 | 1.6 | 1.4 | 2.8 | 1.6 | 1.2 |
| Government expenditure | 1.8 | 1.4 | 1.3 | 0.8 | 1.3 | 0.9 |
| Gross fixed capital formation | 4.1 | 3.1 | 2.9 | 0.5 | 1.9 | 0.9 |
| Inventory | -0.1 | -0.1 | 0.0 | -0.5 | -0.1 | 0.2 |
| Exports | 3.2 | 4.3 | 3.3 | 1.8 | 2.7 | 1.9 |
| Imports | 4.6 | 4.2 | 3.7 | 2.8 | 2.8 | 1.1 |

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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