The Outlook for European Economies

Economy forecast to remain robust despite smouldering political risk

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1. Eurozone

(1) Current Situation

Eurozone real GDP growth in Q3, at 0.6% quarter-on-quarter (QoQ), reached similar heights to the previous quarter's 0.7% QoQ (table 1). Although the breakdown by expenditure of this figure is yet to be published, foreign and domestic demand appear strong, based on monthly indicators. Looking at recent corporate sentiment, manufacturing orders have reached a historical high, and consumer sentiment has also continued to rise following improvement in employment conditions. This healthy corporate and consumer sentiment can be said to be supporting cyclical economic recovery, linking an increase in corporate earnings and household incomes to increased domestic demand.

Turning to real GDP growth in major countries, France is maintaining high growth at 0.5% QoQ, due to increased exports (0.7% QoQ) and capital expenditure (0.9% QoQ), and strong private consumption, up 0.9% QoQ in the context of a recovery in employment. German GDP growth has also accelerated, at 0.8% QoQ, with a large increase in exports, up 1.6% QoQ, providing traction for growth. This is despite a moderate decrease in private consumption of 0.2% QoQ, which comes after prolonged high levels of growth earlier this year.

(2) Outlook

Looking forward, Eurozone economies are expected to maintain domestic demand-led growth. Private consumption is forecast to remain robust following improving health of employment and income conditions, and easing of downward pressure on real incomes due to stabilising inflation. Capital expenditure and exports are expected to maintain a rising trend, supported by the rise in capacity utilisation rates and corporate earnings, and recovery of global economies, respectively. The real GDP growth rate is forecast to exceed the potential growth rate of “slightly above 1%”, at 2.2% year-on-year (YoY) for 2017, and 1.7% YoY for 2018 (chart 1).

In terms of politics, German federal election in September resulted in a reduction of seats for the ruling Christian Democratic Union and Christian Social Union (CDU/CSU). For a stable political administration, the CDU/CSU must form a coalition with other parties, but coalition talks have broken down with the Greens and Free Democratic Party (FDP). The CDU/CSU also face coalition talks with the Social Democratic Party (SPD), Germany's second largest party, who announced that they would go into opposition immediately after the election. However, these talks are not expected to go smoothly, and there is a risk of political destabilisation if a minority government were formed or another election held. A general election is also due to take place in Italy before May 2018, with poll results hinting at the possibility that the ruling party will lose parliamentary seats, with no party achieving a parliamentary majority. For the time being, we do not expect these political risks to have sufficient impact to negatively affect economic recovery. However, these risks do demand attention, as there is a possibility that they will weaken the drive for EU integration over the mid-long term.

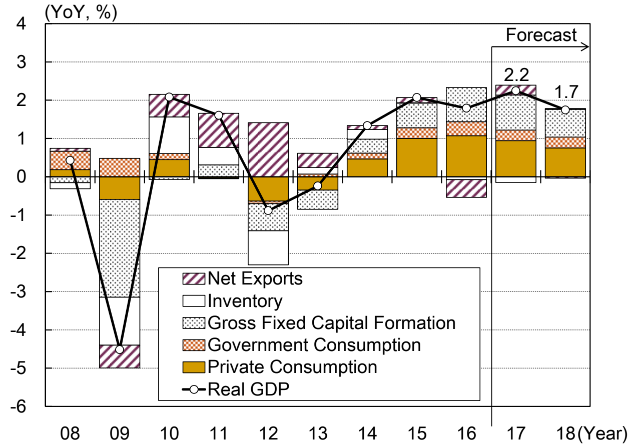
Table 1: Eurozone Real GDP

(QoQ, %)

	2015	2016				2017		
	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9
Eurozone	0.5	0.5	0.3	0.4	0.6	0.6	0.7	0.6
Germany	0.4	0.6	0.5	0.3	0.4	0.9	0.6	0.8
France	0.3	0.6	-0.1	0.1	0.6	0.5	0.6	0.5
Italy	0.3	0.3	0.1	0.2	0.4	0.5	0.3	0.5
Spain	0.9	0.7	0.8	0.7	0.7	0.8	0.9	0.8
Portugal	0.3	0.3	0.2	0.9	0.8	0.9	0.3	0.5
Greece	2.0	-0.9	0.1	0.8	-1.0	0.5	0.5	-

Source: Eurostat, BTMU Economic Research Office

Chart 1: Eurozone Real GDP



Source: Eurostat, BTMU Economic Research Office

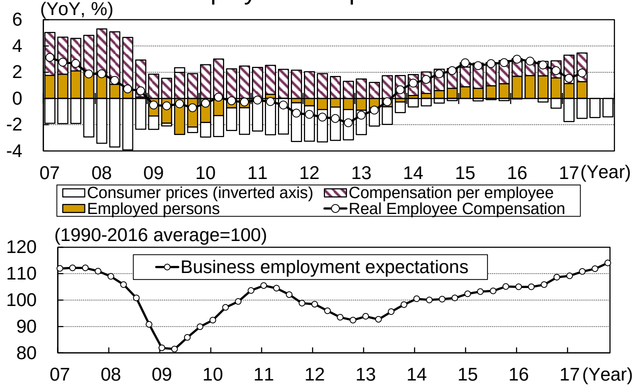
(3) Key Points

① Private consumption to remain robust

Based on GDP data, there is a strong possibility that growth in private consumption remains stable; real retail sales in Q3 are rising at a similar rate to the previous quarter, up 0.6% QoQ, supported by improvement in employment and income conditions. Looking at employment and income conditions as bases for private consumption, the pace of increase in employment has accelerated following increased demand for labour in sectors such as services and construction (chart 2, upper). The chart also shows that compensation per employee is maintaining upward momentum, supported by tightening demand for labour.

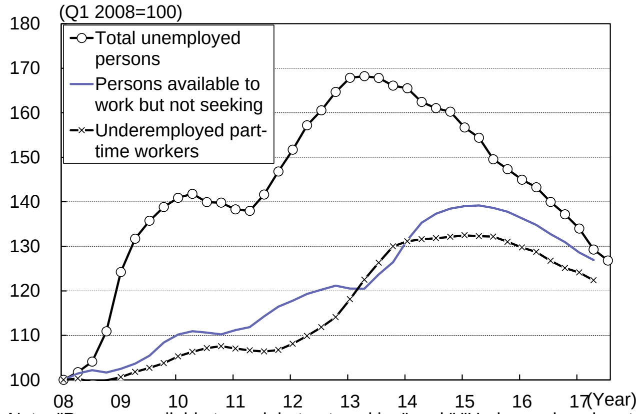
Business employment expectations, which indicate strength of demand for labour, continue to rise led by the services and construction sectors (chart 2, lower). Whilst the unemployment rate and number of persons available to work but not seeking (an indicator of potential supply) are yet to return to pre-Global Financial Crisis levels, this can be interpreted as demonstrating residual potential for the labour market to improve. Furthermore, with downward pressure on real wages continuing to ease following the Q1 peak, and as consumer sentiment continues to improve, we expect to see an ongoing cycle of wage growth connecting to an expansion in private consumption.

Chart 2：Eurozone Employee Compensation, Employment Expectations



Note: "Business employment expectations" use average for manufacturing industry, retail trade, service sector, and construction.
Source: Eurostat, European Commission, BTMU Economic Research Office

Chart 3: Eurozone Unemployment, Underemployment

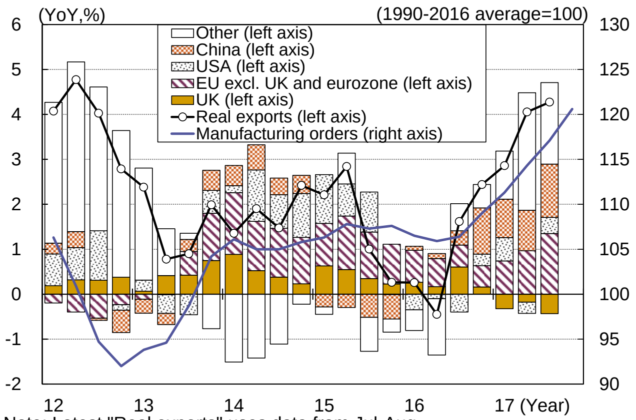


Note: "Persons available to work but not seeking" and " "Underemployed part time workers" are 4 quarterly moving averages
Source: Eurostat, BTMU Economic Research Office

② Recovery of foreign economies to support expansion of exports

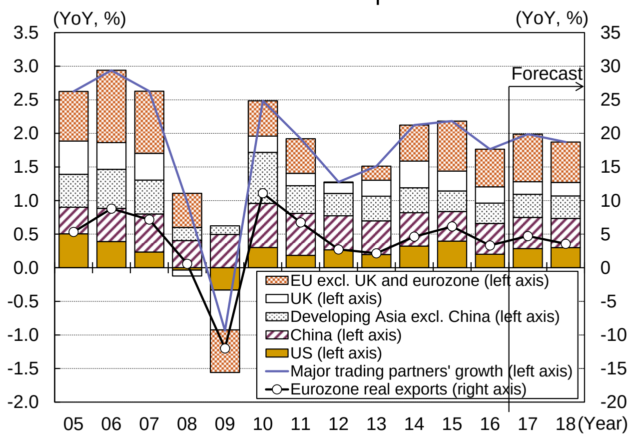
While real exports to the UK have seen a moderate decrease in July-August, exports to other EU countries, China and Russia continue to grow (chart 4). Looking forward, manufacturing export orders are gaining momentum, and demand is forecast to grow in main export markets such as China and USA, meaning that exports are likely to remain robust (chart 5).

Chart 4: Eurozone Real Exports, Manufacturing Orders



Note: Latest "Real exports" uses data from Jul-Aug,
"Manufacturing orders" uses data for Oct-Nov
Source: Eurostat, European Commission, BTMU Economic Research Office

Chart 5: Eurozone Main Export Markets' Real GDP Growth and Exports

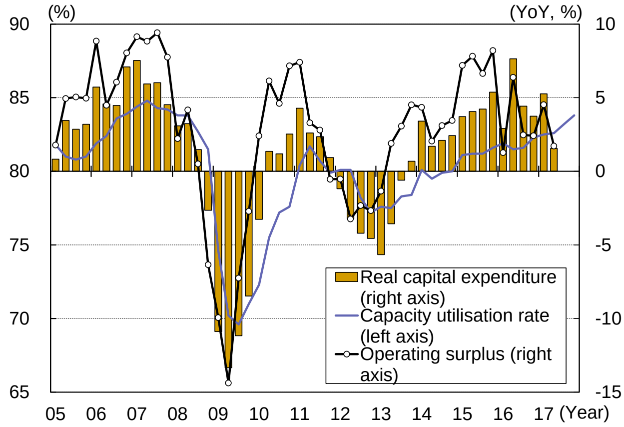


Source: Eurostat, IMF, BTMU Economic Research Office

③ Sustained, but slightly slower growth of capital expenditure

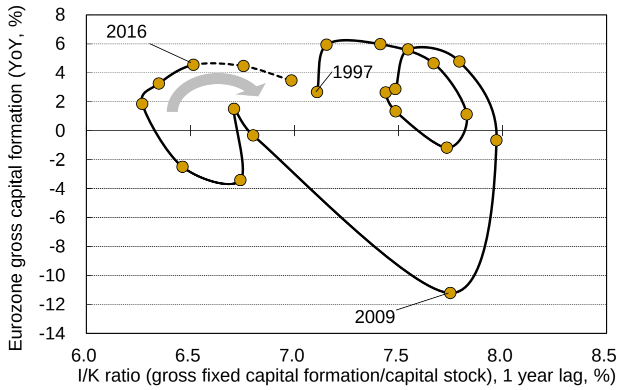
Capital expenditure seems to have maintained momentum in Q3. The capacity utilisation rate is on a rising trend, currently exceeding the pre-Global Financial Crisis (2001-2007) average of 82% (chart 6). Furthermore, based on improvements in the funding environment such as increased corporate earnings and low interest rates, capital expenditure's recovery is expected to continue. Turning to the capital stock cycle, until now, rises in I/K ratio (gross fixed capital formation in relation to capital stock) and gross fixed capital formation have accelerated due to the fact that they were recovering from a significant downturn in the economy. Expansion in the scale of investment is forecast to settle, due to the environment meaning that stock is no longer accumulated on a similar scale to that seen until the 2000s (chart 7). Looking forward, growth in capital expenditure is likely to gradually lose momentum.

Chart 6: Eurozone Capacity Utilisation Rate, Operating Surplus, Real Capital Investment



Source: Eurostat, European Commission, BTMU Economic Research Office

Chart 7: Eurozone Capital Stock Cycle



Note 1. Date range is 1997 to 2018

Note 2. 2017-18 "Capital stock" is European Commission forecast
"Gross fixed capital formation" is BTMU forecast

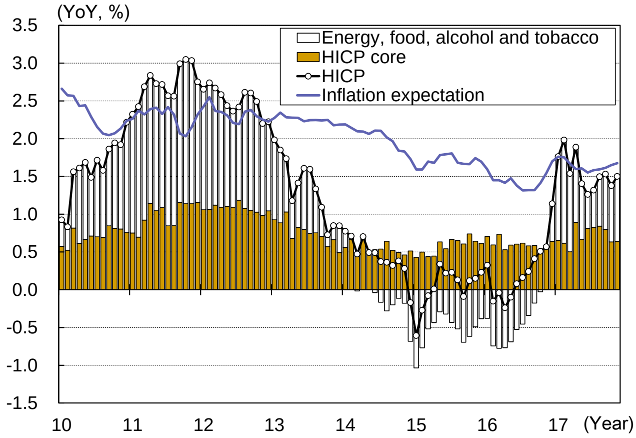
Source: Eurostat, European Commission, BTMU Economic Research Office

(4) Monetary Policy

At the 26th October meeting of the Governing Council of the European Central Bank (ECB), the decision was made to re-extend the asset purchasing program (APP), which had been due to finish at the end of 2017, until September 2018, and to reduce the number of monthly purchases from 60 billion euro to 30 billion euro from January 2018. Policy rates remain unchanged, and any comment on interest rate rises was limited to the announcement that they would “remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases”, with no commitment made upon timeline for rate rises. Consumer price inflation (CPI) is yet to reach the ECB’s policy target of just below 2%, with November seeing a small rise of 1.5% YoY, and subdued acceleration in inflation expectations (chart 8). The gradual reduction of the APP can be thought of as a revision of the quantitative easing program due to lack of eligible bonds, rather than as the ECB actively engaging in quantitative tightening.

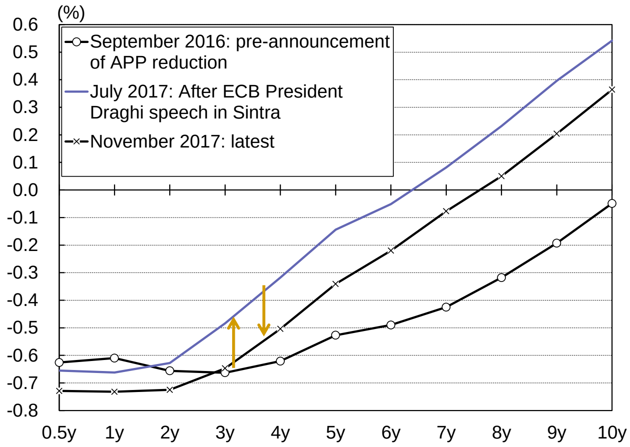
On the other hand, future rate rises started to be incorporated in the market in advance of the ECB’s December 2016 announcement of plans to reduce asset purchases from April 2017. Medium to long term German government bond yields have also risen since autumn 2016 (chart 9). Expectations of interest rate hikes increased further after Mario Draghi, President of the ECB stated that “The threat of deflation is gone and reflationary forces are at play” in his speech at Sintra in June. However, based on the content of recent statements by the Governing Council of the ECB, and cautious statements by key ECB officials, speculation over the possibility of an imminent rate rise is retreating. The macro supply and demand environment has recovered with the economy, but wage growth is limited, and it will take time for inflation to reach target level even after the deflationary gap has closed. It is difficult to foresee a rate rise occurring before the end of 2018.

Chart 8: Eurozone - Inflation



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

Chart 9：Yield Curve for German Government Bonds



Source: Bloomberg, BTMU Economic Research Office

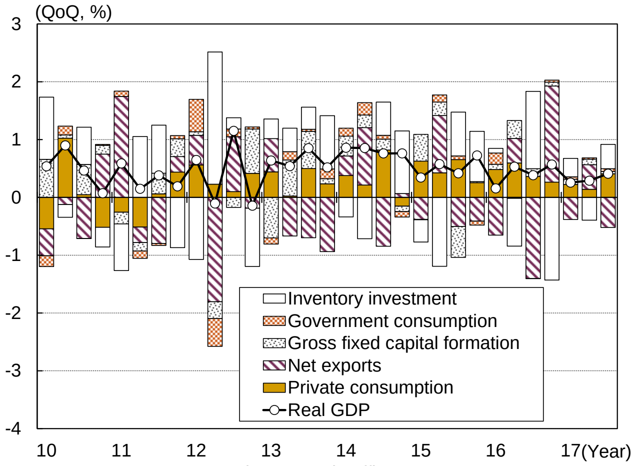
2. UK

(1) Current situation

The UK economy has maintained relative stability until now. The real GDP growth rate for Q3 was 0.4% Quarter on Quarter (QoQ), up from the Q1 and Q2 rate of 0.3% (chart 10).Though net exports (exports-imports) formed a negative contribution to growth, the overall growth rate was pushed up by a positive contribution from inventory investment, and factors such as private consumption showing more growth than the previous quarter.

Turning to Brexit talks, which are the focal point of discussions on the UK economy, the negotiation schedule has been delayed, with no resolution of differences in opinion between the UK and EU (table 2). Originally, stage one negotiations (covering the amount to be paid by UK upon withdrawal, mutual guarantee of citizens' rights, and Northern Ireland border solution) were planned to see significant progress by October, but they have stagnated. Until sufficient progress has been made in stage one negotiations, the EU side will not enter into the second stage of the negotiations, including settlement on a future free trade agreement (FTA) and transition period. This means that delays in the first stage of negotiations will directly affect the amount of time allotted to stage two. Theresa May's domestic leadership is in decline, and it is impossible to ignore the risk of a Brexit cliff edge.

Chart 10: UK Real GDP



Source: ONS, BTMU Economic Research Office

Table 2: Post-referendum Developments and Schedule

2016	
23 Jun	UK votes to withdraw from EU in referendum
2017	
29 Mar	UK announces withdrawal from EU (article 50)
8 Jun	Ruling Conservative party loses majority in UK election
Jun-Nov	6 rounds of negotiations on EU Withdrawal (exit bill etc.) take place, ending without sufficient progress
14-15 Dec	European Council Summit: Stage 2 negotiations (transitional period, post withdrawal FTA) to be postponed if sufficient progress is not made with stage 1 negotiations
Late 2017	Planned conclusion of stage 1 negotiations.
2018	
Oct	Planned conclusion of stage 2 negotiations.
2019	
29 Mar	UK withdrawal from the EU

Source: Various news sources, BTMU Economic Research Office

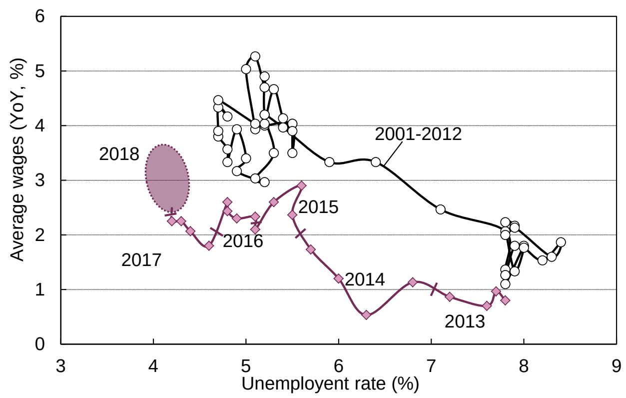
(2) Outlook

Regarding the future of the UK economy, it looks possible that the current level of stability can be maintained if a Brexit cliff edge can be avoided. The domestic sector, though weighed down by continued high inflation, will be supported by healthy employment and income conditions. The unemployment rate was at its lowest level since 1975 in Q3, and corporate hiring intentions are on an improving track. Looking at the relationship between the unemployment rate and wages, in spite of the low unemployment rate of recent years, there is a clear trend for wage growth to remain low compared to historic levels (chart 11). Nonetheless, given the ongoing decline in the unemployment rate to around a 40 year low, a fair amount of upward pressure is now being put upon wages. According to a Bank of England (BoE) business survey, wage growth for 2018, at 2.5-3.5% Year on Year (YoY), is expected to exceed growth in 2017.

The robustness of the manufacturing industry will provide traction in the corporate sector, supported by strong external demand. Industrial production is currently increasing, and is expected to remain robust into the future as orders also continue to be strong (chart 12 upper). Corporates’ expectations of capital expenditure showed increased hesitance in the first half of 2016 before the holding of the EU withdrawal referendum, but have since improved, particularly in manufacturing (chart 12 lower). Actual capital expenditure has also maintained a rising trend since the latter half of 2016, and moderate growth is forecast to continue at the current rate in 2018.

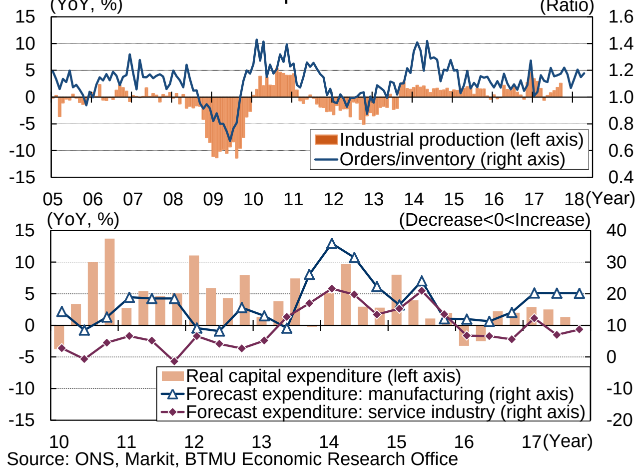
The real GDP growth rate is forecast to avoid a major slowdown, whilst remaining at a level of 1.5% YoY for 2017, a low last seen in 2012. Growth in 2018 is also forecast to remain a relatively stable 1.5%. However, if Brexit negotiations become deadlocked and there is an increased risk of a Brexit cliff edge, falling sentiment and continued depreciation of the pound are likely to continue into the end of 2018, placing significant downward pressure on the economy.

Chart 11: UK Phillips Curve



Note: 2018 "Average wages" from BoE "Agents' summary of business conditions"(2.5-3.5% YoY), "Unemployment rate" from BoE forecast (4.2%).
Source: ONS, BoE, BTMU Economic Research Office

Chart 12: UK Industrial Production, Real Captial Expenditure



Source: ONS, Markit, BTMU Economic Research Office

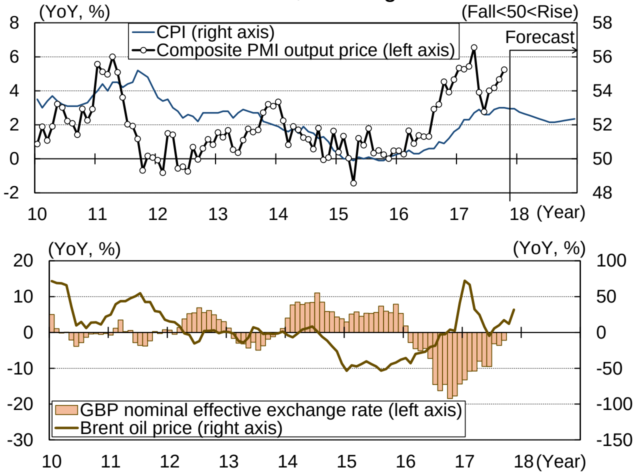
(3) Monetary policy

The Consumer Price Index (CPI) rose 3% YoY in both September and October, a rate last seen in April 2012 (chart 13 upper). One cause of increased inflation, the substantial weakening of the pound, has largely come to a stop (chart 13 lower). However, rises in CPI remain high at present due to the existence of a several month lag in the effect of this on domestic prices. The inflation rate will also continue to be pushed up by acceleration in the rise in oil prices which began in September. For the time being, it is difficult to foresee a sudden drop in inflation, due to the fact that oil prices are expected to maintain moderate growth, and the influence of import inflation resulting from the weak pound is forecast to persist. Inflation is forecast to continue at a high level into late 2018, aided by accelerating wage growth.

With the inflation rate considerably exceeding its 2% YoY target, the Bank of England (BoE) made the decision to raise interest rates by 0.25% points in the 1st-2nd November Monetary Policy Committee (MPC) meeting (table 3). BoE Governor Mark Carney also indicated at the press conference that two further rate rises of 0.25% points are considered necessary before 2020 in order to bring inflation down to the target level.

Looking ahead, the BoE is expected to freeze monetary policy for the time being in order to ascertain the effects of the rate rise and pace of easing in pressure of imports inflation. In the latter part of 2018, it is possible that wage rises could considerably increase upward pressure on prices, but whilst caution remains over the risk of a Brexit cliff edge, it is highly likely that further rate rises will be postponed.

Chart 13: UK CPI, Leading Indicators



Source: ONS, Bloomberg, BTMU Economic Research Office

Table 3: Summary of November MPC meeting

Decision and Context
• Increase policy rate by 0.25% points, to 0.50% (7 votes for, 2 votes against). • Maintain stocks of UK government bond purchases (£435 billion) and non-financial investment-grade corporate bond purchases (£10 billion) (unanimous agreement). • It is no longer acceptable for the inflation rate to exceed the target level (2%) for a prolonged period due to tightening of the supply/demand balance.
Economic Outlook
• For the next few years, GDP growth will continue at a level slightly above the potential growth rate (around 15%). • Inflation will level off, but will remain above the 2% target form the time being due to factors such as continued import inflation and the effects of tightening supply/demand balance. • Economic forecast is based on the assumption that Brexit talks will go smoothly.
Monetary Policy Outlook
• Monetary policy must maintain the balance between its effect to support the economy and the speed at which inflation is brought down to target level. • Future rate increases will be small scale and moderate in pace. • Financial markets are comfortable with preparing for a total interest rate rise of 0.50% by the end of 2020. • The inflation rate is expected to approach the target level by the end of 2020 by means of two further rate rises.

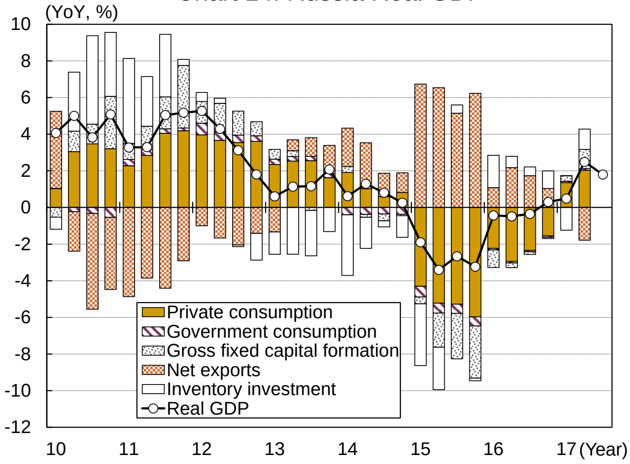
Source: Various news sources, BTMU Economic Research Office

2. Russia

(1) Current situation

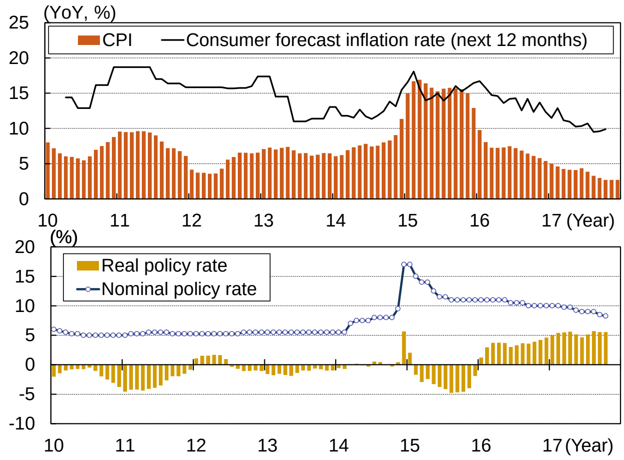
The Russian economy has been improving since late 2016. For the last 6 months, growth has been sustained at a relatively high level, demonstrating a clear recovering trend with Q2 real GDP growth up 2.5% YoY, and Q3 up 1.8% YoY (chart 14). The economic recovery is being aided by improvement in the market for oil and gas, which make up approximately 70% of exports, and easing of inflationary pressure on imports following ruble market price stabilisation. This is particularly true in terms of prices, where temporary factors such as the rich grain harvest combine with Consumer Price Inflation (CPI) at 2.7% YoY in October, which marks the fourth consecutive month below the Bank of Russia's target of 4% YoY (chart 15 upper). One factor in the continued economic recovery is the fact that the central bank is delivering gradual interest rate reductions following a slowdown in inflation (chart 15 lower).

Chart 14: Russia Real GDP



Source: Rosstat, BTMU Economic Research Office

Chart 15 Russian Inflation and Policy Rates



Source: Rosstat, Bank of Russia, BTMU Economic Research Office

Turning to the household sector, an improvement of employment and income conditions has contributed to a rally in consumer sentiment, and autumn auto sales have seen close to a 20% increase YoY. The corporate sector is also improving, with gross fixed capital formation for Q2 at a five year high of 6.8% YoY, as well as the ongoing improvement in appetite for capital expenditure.

(2) Outlook

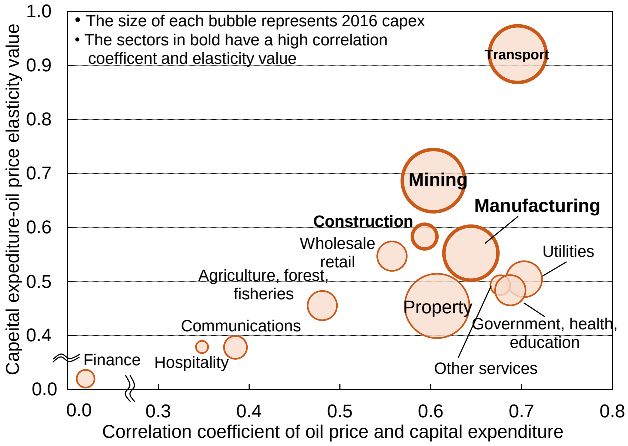
Following on from this, there is a high likelihood that the Russian economy will continue on an improving track. There is a strong probability that employment and income conditions will continue to improve due to an improvement in corporate hiring intensions, and private consumption will provide traction for economic recovery. Improvement is highly likely to continue in capital expenditure, particularly in sectors with a strong correlation with oil prices, such as transport (mainly pipeline), mining, manufacturing, and construction (chart 16). However, oil prices, which have considerable influence over the Russian economy, are forecast to maintain a rising trend in 2018, without reaching high prices[1]. This means that capital expenditure is not expected to noticeably accelerate the economy as a whole.

The Russian government has also based estimates of future energy revenues (roughly 40% of annual expenditure) on conservative oil price forecasts, and plans to continue tightening fiscal policy for the time being. Annual expenditure growth will turn negative by a moderate 0.5% YoY (in nominal terms) in 2018, constricting the economy. As a result, there is a strong probability that real GDP growth will remain low compared to pre-recession levels[2]. Real GDP growth rate for 2017 is expected to turn positive for the first time in three years at 1.7% YoY, but only expected to accelerate slightly in 2018 to 1.9% YoY.

[1] We expect WTI oil price for 2018, at US$54 per barrel (yearly average) to slightly exceed 2017's US$50 per barrel (yearly average).

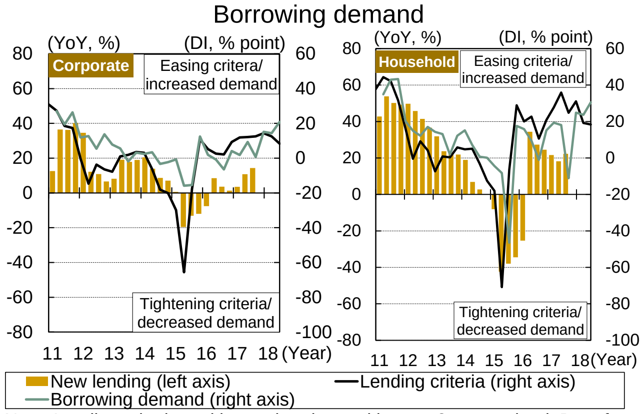
[2] Average real GDP growth for 2010-2014 was 3.0% YoY. The pre-Global Financial Crisis average for 2000-2008 was 7.0% YoY.

Chart 16: Russian Capex by Sector vs Oil Prices



Source: Rosstat, Bloomberg, BTMU Economic Research Office

Chart 17：Russian Bank Lending, Lending Criteria, Borrowing demand



Note: Lending criteria and borrowing demand have a 2 quarter lead. Data for Q2 and Q3 are forecast based on surveys.

Source: Bank of Russia, BTMU Economic Research Office

Moving to monetary policy, bank lending to both corporates and households is currently on an established increasing trend (chart 17). Looking forward, we expect lending to increase further, as borrowing demand is forecast to rise and banks are expected to ease lending criteria.

Interest rate reductions by the Bank of Russia are also expected to stimulate borrowing demand. The current real policy rate (nominal policy rate less CPI growth rate), is above 5%, considerably higher than the historic average (previous chart 15 lower). There is a strong possibility that the Bank of Russia will reduce interest rates in line with the present real equilibrium interest rate of 2.5-3.0%. However, given concern over existing high inflation expectations (previous chart 15 upper), rate reductions are likely to be implemented at a cautious pace.

In terms of major events taking place in 2018, the presidential election will be held in March, and the FIFA (Federation Internationale de Football Association) World Cup will be held in June-July. President Putin's re-election is seen as assured, given his high approval rating and the lack of a strong opposition candidate. Politically speaking, Putin's vote share will draw attention as an indicator for the future strength of his powerbase. On the other hand, from an economic point of view, there is little possibility of the presidential election causing turbulence.

The FIFA World Cup will bring increases in private consumption and international visitor numbers. According to FIFA estimates, total spectator numbers will reach approximately 3 million, with approximately 1 million spectators expected to come from abroad to see the tournament. This is expected to aid economic growth[3].

[3] Past World Cup spectator numbers were 3.43 million for Brazil in 2014, and 3.17 million for South Africa in 2010. Numbers of international visitors to Brazil were up 0.62 million YoY in 2014, and were up 1.48 million YoY to South Africa in 2010.

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