The Outlook for European Economies

Economy forecast to remain healthy despite simmering political uncertainty

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1. Eurozone

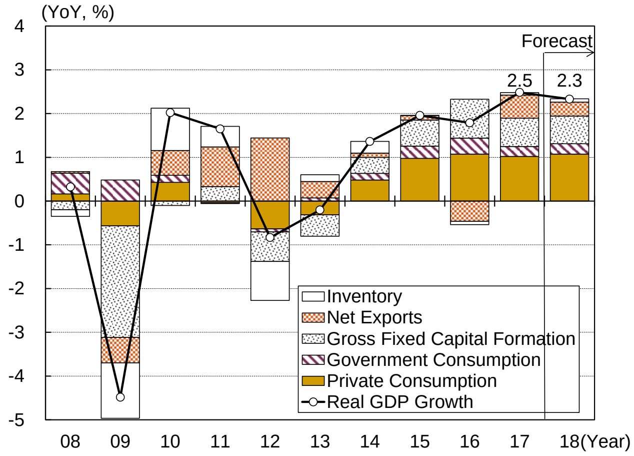
(1) Overview of the Eurozone Economy

Eurozone real GDP growth remained high in October-December 2017 at 0.6% quarter-on-quarter (QoQ), despite slowing slightly from previous quarter's 0.7% QoQ. Although the breakdown by expenditure of this figure is yet to be published, foreign and domestic demand appear strong, based on monthly indicators for sales, production and trade. On a national level, Germany, which is the largest economy in the area, saw acceleration in exports provide traction for real GDP growth of 0.6%, despite slow private consumption. In France, exports are healthy whilst private consumption and capital expenditure are robust, with the pace of real GDP growth speeding up to 0.6% QoQ. Italian GDP growth is maintaining its recovery at a relatively low rate of 0.3% QoQ.

Looking forward, Eurozone economies are expected to remain healthy. Rises in private consumption and capital expenditure look likely to continue, supported by sustained improvement in employment and income conditions, and factors like corporate earnings, respectively. Exports are also expected to maintain momentum, with expansion of the world economy and acceleration in economies such as the US. Real GDP growth for 2018 is expected at 2.3% year-on-year (YoY) a slight decline from the 10 year highs of 2017, 2.5%YoY. Nonetheless, growth is forecast to considerably exceed the potential growth rate of "slightly above 1% YoY" (chart 1).

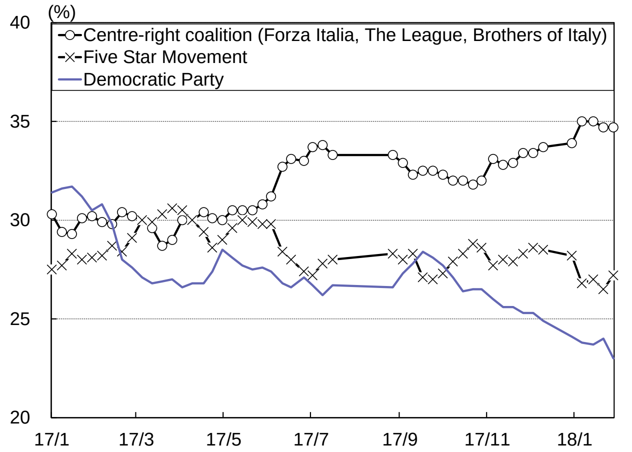
In Germany, the Social Democratic Party (SPD) is planning to announce the result of a party vote on 4th March on whether or not to enter a coalition with the Christian Democratic Union and Christian Social Union (CDU/CSU), headed by Chancellor Angela Merkel. The Italian general election will also be held on 4th March, with the centre-right coalition leading in the polls, with the ruling Democratic Party (PD) trailing behind (chart 2). With no party (including the five star movement) expected to attain a majority of parliamentary seats, all eyes will be on the progress post-election coalition negotiations. We do not expect these political risks to have sufficient impact to negatively affect economic recovery, the situation requires monitoring for the possibility that it might affect the future economy over the medium to long term, for example through policy change.

Chart 1: Eurozone Real GDP Growth Forecast



Source: Eurostat, BTMU Economic Research Office

Chart 2：Major Italian Political Parties' Approval Ratings

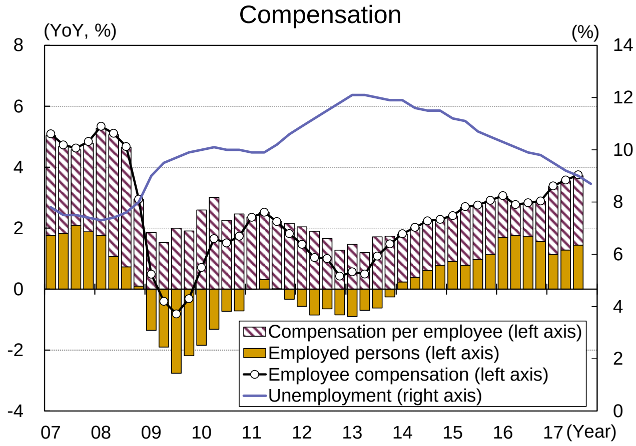


Source: EMG Acqua, BTMU Economic Research Office

(2) Key Points of the Outlook

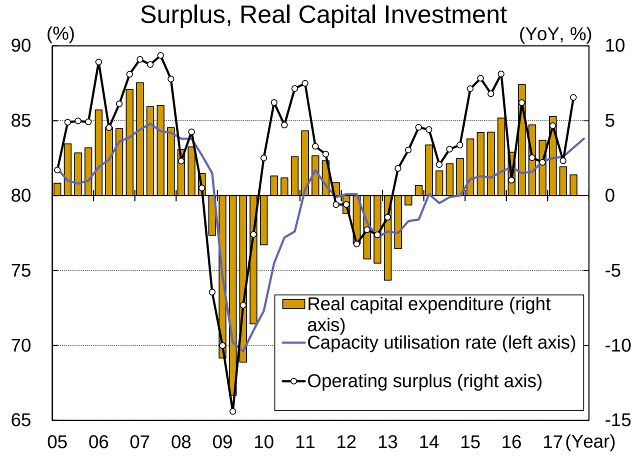
Turning to private consumption, which shapes the direction of the economy, the continued improvement of employment and income conditions, which are bases for expenditure growth such as decrease in unemployment, is a positive factor (chart 3). With business employment expectations and consumer sentiment remaining at high levels, it is likely that increase of wages will continue to support expansion in consumption. Though capital expenditure is also showing signs of pent up demand being satisfied, capacity utilisation rate remains on a rising trend, currently at a 10 year high (chart 4). Based on increased corporate earnings and robust corporate capital demand, it seems likely that capital expenditure will continue to see moderate growth.

Chart 3: Eurozone Unemployment, Employee Compensation



Source: Eurostat, European Commission, BTMU Economic Research Office

Chart 4: Eurozone Capacity Utilisation Rate, Operating Surplus, Real Capital Investment

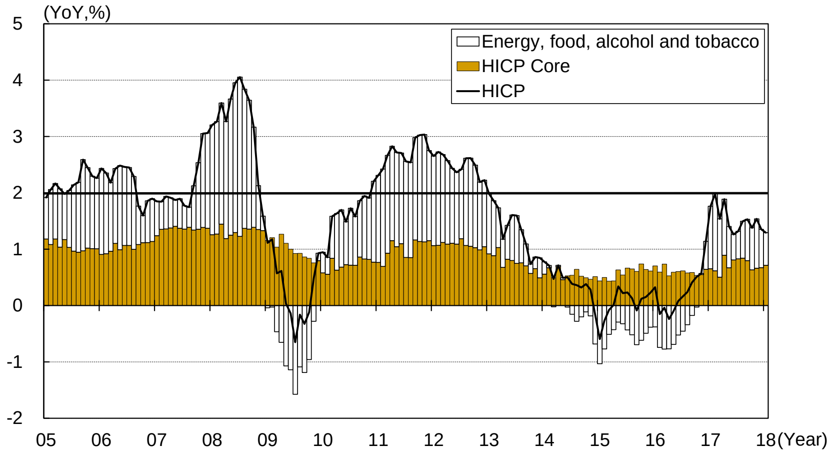


Source: Eurostat, European Commission, BTMU Economic Resarch Office

In terms of monetary policy, the European Central Bank (ECB) halved monthly net asset purchases to 30 million euro from January, with the purchase period “intended to run until the end of September 2018, or beyond, if necessary”. Purchase policy from October is expected to be announced at the June or July monetary policy meeting, but the asset purchasing program

(APP) is likely to end by the end of 2018. However, consumer price inflation (CPI) is below the ECB target rate of “just below 2%”, and rises in core items have been sluggish (chart 5). The ECB is expected to revise its forward guidance at sooner or later, but it is hard to foresee a rate rise within the year given the ECB’s continued cautious stance on policy rates.

Chart 5：Eurozone Inflation



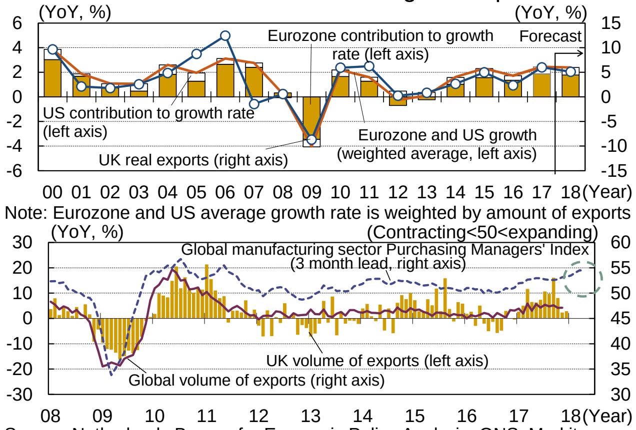
Source: Eurostat, BTMU Economic Research Office

2. UK

The UK economy has maintained relative stability until now despite being hindered by uncertainty over the future of Brexit. Real GDP growth maintained moderate upward momentum in October-December 2017, at 0.4% QoQ. Since early last year, robust external demand, paticulary in the Eurozone, has supported the economy, and increase in the rate of real exports for 2017 reached a 6 year high at 5.0% YoY (chart 6 upper).

In Brexit negotiations, discussions are currently underway about the transition period which is set to take place after the UK is due to withdraw from the EU (29th March 2019). The EU and UK have agreed that for a state of affairs similar to the current situation should be maintained for a set period of time, in order to avoid disrupting corporate activites and citizens’ lives. However, there are differences of opinion about the details of this transition period (table 1). The aim was to reach an agreement on the transition period before the EU summit in late March, but at present, there is an undeniable risk that this could be delayed.

Chart 6: Climate Surrounding UK Exports



Source: Netherlands Bureau for Economic Policy Analysis, ONS, Markit, Eurostat, US Department of Commerce, BTMU Economic Research Office

Table 1: Issues Surrounding the Transition Period

	UK	EU
Duration	Roughly 2 years with potential for extension	Ends December 2020
EU Regulation	Demand the right to veto EU decisions made during transition period	The UK will be bound by all EU regulation during the transitional period, with no influence on the policy making process
Freedom of movement	Set up new immigration system	Freedom of movement should apply to migrants entering the UK during the transition period
FTA negotiations with third countries	Formal FTA negotiation possible (for implementation after transition period)	UK can negotiate FTA with third countries, but cannot conclude them within transition period

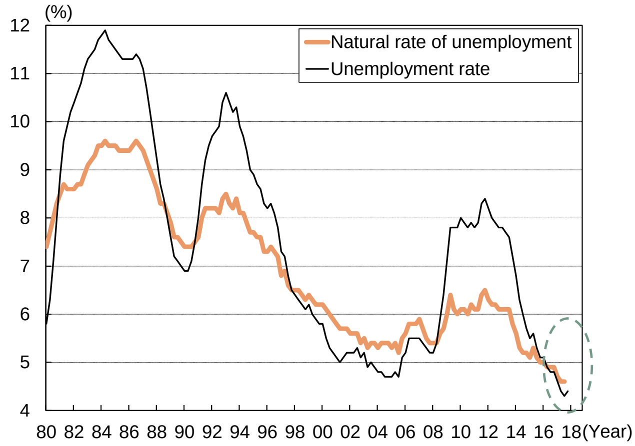
Source: UK Government, European Commission, various news sources BTMU Economic Research Office

Looking forward, the UK looks likely to maintain its current level of economic stabiliy providing Brexit cliff edge can be avoided. External demand is likely to become a factor supporting the economy. Manufacturing production activity is gaining strength globally, and trade volumes are expected to continue to see stable expansion for the time being (chart 6 lower). In particular, the UK is likely to be assisted by the Eurozone and USA, which are major export markets maintaning healthy economies.

Turning to domestic demand, though persistently high inflation (discussed below) will be a factor dampening purchasing power, a healthy employment enviroment is expected to combine with increase in the pace of wage rises to contribute to economic stability by raising household incomes. Unemployment, at 4.4% in December 2018, is curently at a low level not seen since the 1970s, and the vacancy rate has risen to its highest level since 2000. As the unemployment rate drops below the natural unemployment rate, a corresponding amount of upward pressure is judged to be placed upon wages (chart 7). UK real GDP growth for 2018 is expected to maintain a stable level of 1.6% YoY, simiar to last year’s growth of 1.7% YoY.

The trend in inflation merits close attention. CPI inflation rate for January was 3.0% YoY, considerably exceeding the Bank of England (BoE) target of 2.0% YoY. The depreciation of the pound which was the main cause of high inflation has settled, but its influence remains due to the lag that exists in the ripple effect of import price rises on domestic prices. Bearing in mind factors such as rising wages and oil prices, it is likely that inflation will continue to exceed BoE’s target until at least late 2018 (table 2). In the event of increased fears over hightening inflation, further BoE interest rate rises will become more likely.

Chart 7: UK Unemployment, Natural Unemployment



Source: ONS, BoE, BTMU Economic Research Office

Table 2: UK CPI Scenarios

Scenario	Condition precedent			CPI (YoY)
	Exchange rate (YoY)	WTI Price (per barrel)	Average wages (YoY)	
Main	**4.9%**	**60 USD**	**3.5%**	**2.2%**
High Oil Price	4.9%	70 USD	3.5%	2.4%
Weak Pound	-10.0%	60 USD	3.5%	2.4%
Strong Pound	10.0%	60 USD	3.5%	2.0%
High wage growth	4.9%	60 USD	4.5%	2.3%

Note 1: Each parameter is the average value for Oct-Dec 2018
Note 2: "Exchange rate" is nominal effective exchange rate.
Source: ONS, BoE, BTMU Economic Research Office

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