The Outlook for European Economies

Economy remains robust, but high growth period expected to draw to an end

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1. Eurozone

(1) Overview of the Eurozone Economy

Eurozone real GDP growth for Q1 slowed from 0.7% quarter-on-quarter (QoQ) to 0.4% QoQ, reflecting temporary factors such as the cold snap and strikes(Table 1). Looking at countries where the breakdown by expenditure of this figure has been published, domestic demand was robust in France and Germany, but growth in exports was markedly sluggish, slowing to 0.3% in both countries. Whilst it is clear that the domestic demand-led recovery of Eurozone economies is ongoing, taken together with falls in the composite economy Purchasing Managers Index (PMI) in April and May, it seems that economic growth momentum is slowing somewhat.

In the Eurozone, recovery of unemployment and capacity utilisation rates continues, so the buoyant growth rates that have been seen until recently appear to be drawing to an end. Looking forward, both private consumption and capital expenditure are expected to maintain upward trends, based respectively on a continued improvement in the employment environment, and growth in corporate earnings. However, the pace of these trends is likely to gradually slow. Real GDP growth is predicted to remain stable whilst undergoing a moderate slowdown, forecast at 2.2% YoY for 2018, and 1.8% YoY in 2019 (Chart 1).

Turning to politics, a political vacuum has existed in Italy since the general election in March. The Five Star Movement and League agreed upon a policy agenda in May, with the aim of forming a coalition agreement. Nevertheless, political unease subsequently increased sharply after the leaders of each party abandoned cabinet formation due to issues with ministerial appointments. Whilst a Europhile former IMF official was newly nominated as prime ministerial candidate on 28th May, opposition from Five Star Movement and the League, which are both Eurosceptic proponents of expansionary fiscal policy, seems inevitable, and concerns are mounting over political confusion and fiscal deterioration.

At the time of writing, Italian bond yields are rising sharply, with concerns over the potential formation of a negative cycle of “increased interest burden ⇒ fiscal deterioration ⇒ rising bond yields”. With rumours of another election within the year, the future direction of Italian politics merits close attention.

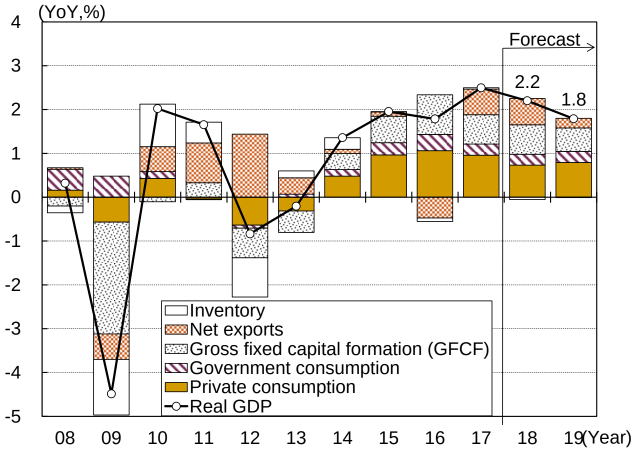
Table 1: Real GDP Growth Rates in Major European Countries

(YoY, %)

	2016				2017				2018
	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Eurozone	0.5	0.4	0.4	0.6	0.6	0.7	0.7	0.7	0.4
Germany	0.6	0.5	0.3	0.4	0.9	0.6	0.7	0.6	0.3
France	0.6	-0.1	0.2	0.5	0.7	0.6	0.5	0.7	0.3
Italy	0.3	0.1	0.2	0.5	0.5	0.4	0.4	0.3	0.3
Spain	0.7	0.8	0.7	0.7	0.8	0.9	0.7	0.7	0.7
Portugal	0.2	0.2	1.2	0.7	0.7	0.3	0.6	0.7	0.4
Greece	-0.6	-0.4	0.5	-0.4	0.6	0.7	0.4	0.1	-

Source: Eurostat, MUFG Bank Economic Research Office

Chart 1: Eurozone Real GDP Growth Forecast

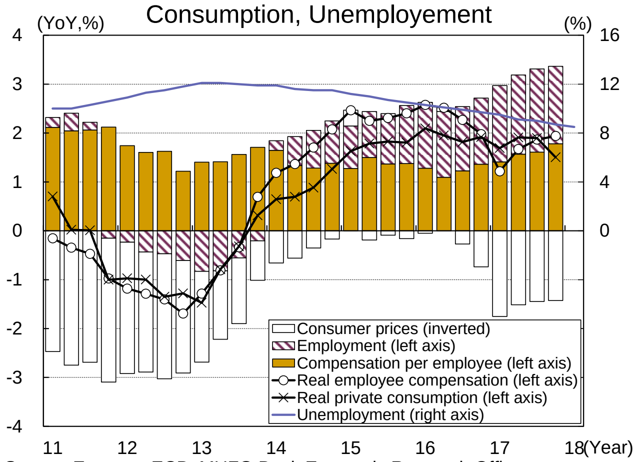


Source: Eurostat, MUFG Bank Economic Research Office

(2) Key Points of the Outlook

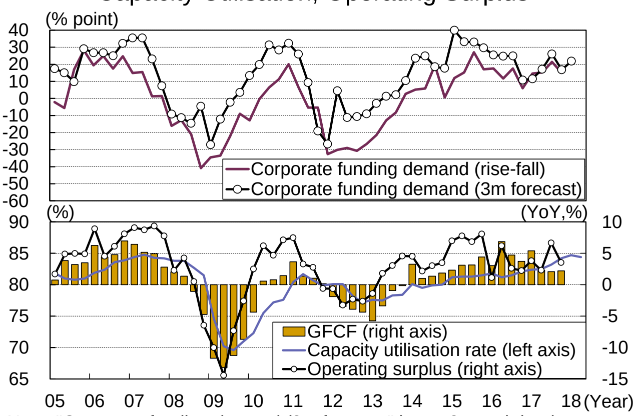
There remains room for improvement in employment and income conditions in the Eurozone, particularly in Southern Europe and France. On the whole, it seems that the pattern of rising incomes supporting expansion in consumption is likely to continue (Chart 2). In countries like Germany, where the economy has already recovered, accompanied by a drop in unemployment, employment expansion is expected to gradually moderate in pace. Capital expenditure looks likely to maintain a rising trajectory, based on increased corporate earnings and robust corporate funding demand (Chart 3). However, it is expected to gradually lose momentum, given that the capacity utilisation rate is currently at an 11-year high, and pent up demand is beginning to peak.

Chart 2: Eurozone Employee Compensation, Private Consumption, Unemployement



Source: Eurostat, ECB, MUFG Bank Economic Research Office

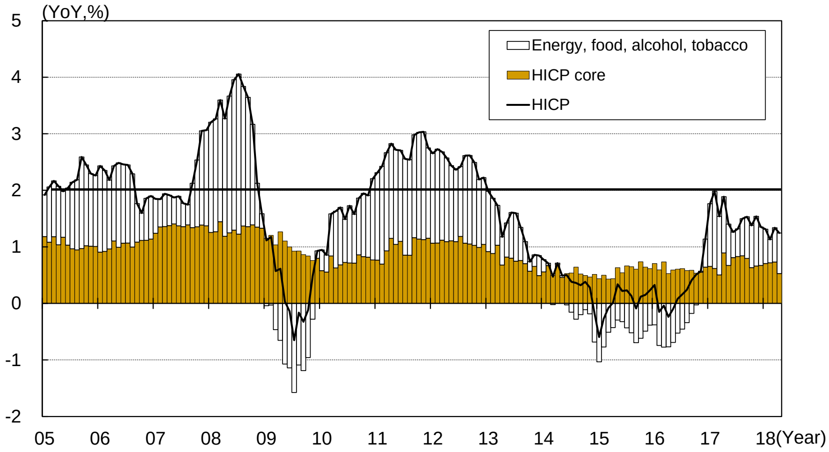
Chart 3: Eurozone Corporate Funding Demand, GFCF, Capacity Utilisation, Operating Surplus



Note: "Corporate funding demand (3m forecast" has a 3 month lead
Source: Eurostat, ECB, MUFG Bank Economic Research Office

In terms of monetary policy, the European Central Bank (ECB) is carrying out its asset purchase programme, which is planned to draw to a close by the end of September. Purchase policy from October is expected to be announced at the monetary policy meeting in July, and asset purchases are likely to end within the year despite the need to monitor the trends in Eurozone bond markets due to factors such as Italian political instability. Nevertheless, consumer price index (CPI) inflation remains below the ECB target of “just below 2% YoY” (Chart 4). Inflation is expected to rise to some extent in the short term from the influence of high oil prices, but given the sluggish acceleration in core inflation, interest rate rises are unlikely this year. The ECB will proceed cautiously with its exit strategy, and is likely to delay policy rate normalisation until late 2019, when it will raise the deposit facility rate(from -0.40% to -0.20%).

Chart 4: Eurozone Harmonised Index of Consumer Prices (HICP)



Source: Eurostat, MUFG Bank Economic Research Office

2. UK

The UK’s real GDP growth rate slowed to 0.1% quarter-on-quarter (QoQ) in January-March due to factors such as heavy snow, but essentially remained robust. Looking at the breakdown by expenditure, private consumption rose by just 0.2% QoQ, a low last seen in October-December 2014, whereas GFCF maintained a comparatively large rise of 0.9% QoQ, based on factors such as investment in machinery.

In Brexit negotiations, a provisional agreement relating to the transitional period was approved at the March EU summit, meaning that there is a higher likelihood that a situation close to the current one will continue after withdrawal (planned for 29th March 2019) until the end of 2020. However, there exist significant differences of opinion between the UK and EU on issues such as the handling of the Northern Irish border, and negotiations are expected to remain troubled (Table 2). Within the UK, though Theresa May supports leaving the customs union, there is rising support in parliament for continued membership, putting the prime minister in an increasingly difficult position. Following on from this, we must pay close attention to the risk of UK political confusion delaying Brexit negotiations.

Looking at the future direction of the economy, despite the risks mentioned above, assuming that the “Brexit cliff edge” scenario doesn’t materialise, we forecast real GDP growth will be relatively stable at 1.6% YoY for 2018 and 1.5% YoY for 2019. This is because the economy is expected to be supported by the robust global economy boosting exports, and the continued expansion of capital expenditure (Chart 5).

Table 2: Ongoing issues regarding Brexit

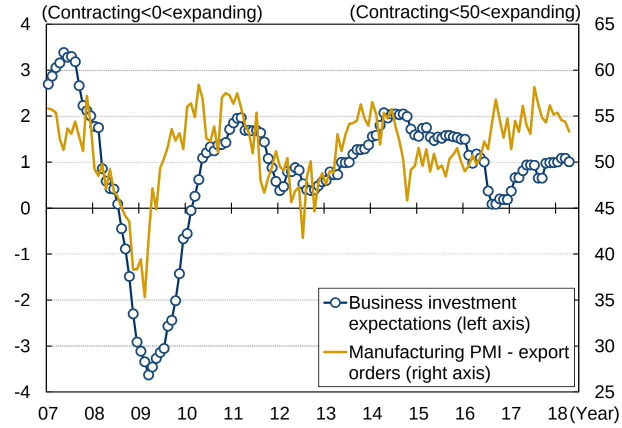
1. EU summit 28-29 June
A judgement will be made on measures to avoid a hard border in Northern Ireland. The UK has proposed 2 options: ① The conclusion of a customs partnership, ② Use of cutting-edge technology to avoid revival of customs checks, but the EU has rejected both as unrealistic. If UK suggestions are rejected, the likelihood of the EU “common regulatory area” proposal being adopted will increase.

2. The vote on the withdrawal bill due in autumn
Whilst Theresa May supports leaving the customs union, there is rising support in parliament for continued membership of the customs union, potentially putting the prime minister in a difficult position.

3. Around the EU summit on 18-19 October
Deadline for withdrawal agreement. There is a risk that the current provisional agreement for a transitional period could become void until agreement is reached on all points of the negotiation.

Source: Various sources, MUFG Bank Economic Research Office

Chart 5：UK Business Investment Expectations, Export Orders

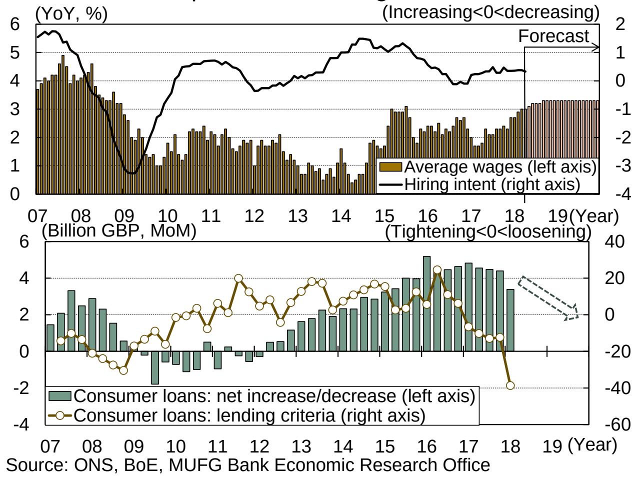


Source: BoE, IHS Markit, MUFG Bank Economic Research Office

However it should be considered likely that private consumption, which is the largest component of GDP, will continue to lack strength. Certainly, the employment and income environment is healthy, with unemployment currently at 4.2%, below natural unemployment (4.25% according to the Bank of England (BoE)), and businesses still positive towards expanding employment (Chart 6 upper). Real purchasing power can also be expected to recover, due to wage inflation rising as a reflection of the tightening labour supply-demand balance combining with a slowdown in inflation (see detail below). However, the fact that growth in consumer loans, which had been supporting expansion of private consumption, seems to be slowing since early this year, is a concern (Chart 6 lower). Based on the fact that lending criteria are also tightening, it seem inevitable that the slowdown in consumer loans will be exacerbated, becoming a factor limiting private consumption.

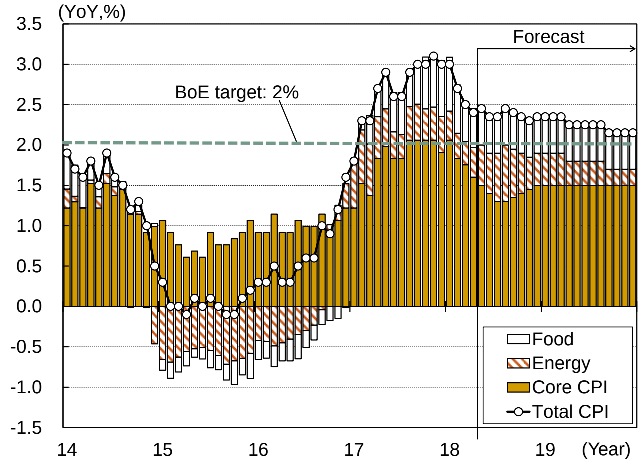
In terms of prices, inflationary import pressure resulting from the weak pound has begun to recede, and CPI inflation slowed to 2.4% YoY in April (Chart 7). Nevertheless, bearing in mind the influence of steep rises in oil prices until now, and the expected pick up in wage inflation, the inflation rate is not expected to drop below the Bank of England (BoE) target of 2% for the time being. While the BoE looks likely to refrain from raising interest rates until after the critical point in Brexit negotiations, we expect a rate rise around February 2019, once inflationary pressure due to wage growth becomes evident.

Chart 6：UK Emploment and Wages, Consumer Loans



Source: ONS, BoE, MUFG Bank Economic Research Office

Chart 7: UK CPI



Source: ONS, MUFG Bank Economic Research Office

3. Russia

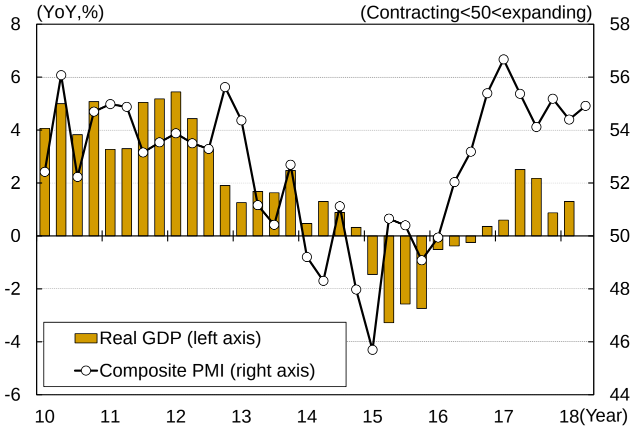
The Russian economy is on a path of moderate recovery. Real GDP growth for January-March at 1.3% YoY, was a sixth consecutive quarter of positive growth (Chart 8). April's composite PMI, at 54.9, also maintained a comparatively high level, meaning that the recovery is ongoing. Recovery in oil prices is supporting the energy sector, a key industry for Russia, and private consumption is on a recovery track due to lower inflation. The Bank of Russia is supporting the economic recovery with gradual interest rate cuts, against a backdrop of lower inflation expectations and CPI inflation being below its 4% target.

We expect the Russian economic recovery to continue, but close attention must be paid to the risk of a rebound in inflation. In April, the rouble came under selling pressure from the strengthening of US economic sanctions against Russia, meaning that the current exchange rate has fallen to figures last seen in late 2016, of 1 USD to 60-65 RUB. Reflecting heightening inflationary pressure due to currency weakness, input price, which is a component of the PMI, accelerated in April to its highest rate since September 2015 (Chart 9). Looking forward, factors such as rising inflation pushing down households' real purchasing power and slower policy rate cuts from the Bank of Russia are likely to restrain economic growth.

Comparing the current situation to the large scale depreciation in the rouble that occurred around 2015, US sanctions at the time had been supplemented by low oil prices prompting a sell-off in the rouble, whereas oil prices are now on a rising trend. Looking forward, given that oil prices are expected to remain comparatively high (WTI prices over 60USD per barrel), weakening of the rouble and resultant rises in inflation are expected to remain relatively minor. CPI inflation is expected to accelerate from its current rate of around 2.5% YoY, but is unlikely to significantly exceed the Bank of Russia's inflation target.

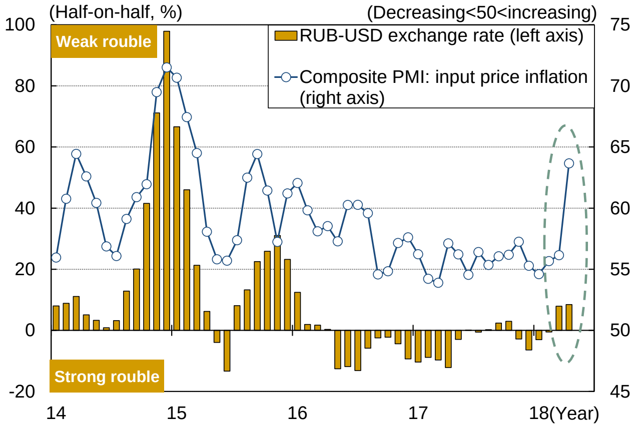
As a whole, the economy is expected to see continued recovery, with robust corporate appetites to hire and for capital expenditure against a backdrop of increasing oil prices since early spring. The hosting of the FIFA world cup in June and July of this year is also expected to support the economy. Real GDP growth for 2018, at 1.8% YoY, is expected to be higher than 2017 (1.5% YoY), with moderate growth predicted to continue for 2019 at 1.7% YoY.

Chart 8：Russian Real GDP and Composite PMI



Note: Latest Composite PMI figure uses data from April 2018 only.
Source: Rosstat, IHS Markit, MUFG Bank Economic Research Office

Chart 9: Rouble Exchange Rates,
Russian Composite PMI Input Price



Source: Rosstat, IHS Markit, MUFG Bank Economic Research Office

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