The Outlook for European Economies

Domestic demand-led moderate economic growth forecast to continue

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1. Eurozone

(1) Overview of the Eurozone Economy

Eurozone real GDP growth for Q2, at 0.4% quarter-on-quarter (QoQ), maintained the same rate of robust growth recorded in Q1 (Table 1). Looking at countries where the breakdown by expenditure of this figure has already been published, government spending has gained momentum in Germany, and the pace of growth has quickened due mainly to domestic demand factors, such as strong private consumption. In France, while sluggish net exports were a drag on the economy and GDP grew by only 0.2% QoQ, gross fixed capital formation (GFCF) remained steady. In the Eurozone as a whole, compared to last year which saw healthy domestic and external demand, the economy is now losing momentum, partially due to recent euro appreciation. Nevertheless, domestic demand-led moderate economic growth looks set to continue. Looking forward, private consumption is expected to see continued expansion on the back of improved labour conditions, and capital expenditure on growth in corporate earnings. Real GDP growth is expected to slow slightly as the output gap approaches equilibrium, with growth forecast at 2.0% year-on-year (YoY) for 2018, and 1.8% YoY for 2019, slightly above its potential (around 1.5%) (Chart 1).

However it is worth noting that from a political and policy point of view, numerous risks abound that have potentially negative consequences for the economy. First among these is Italian fiscal policy. In financial markets, Italian bond yields have remained high, as concern simmers over the possibility of fiscal deterioration, focusing the draft budgetary plan due to be submitted to Italy's parliament in late September. Whilst expansionary fiscal policy itself stimulates the economy, any further rise in bond yields risks resulting in a negative environment of increased debt burden and fiscal deterioration. A number of other risks warrant close attention: 1) The risk of a drop in exports to the UK caused by unrest in the financial markets and a downturn in the UK economy in the case of a 'Brexit cliff-edge' scenario, 2) The potential for negative effects on the economy of countries like Germany if US tariffs are imposed on the automotive sector 3) The sudden slide in the Turkish lira, and spread of its effects to the European financial sector.

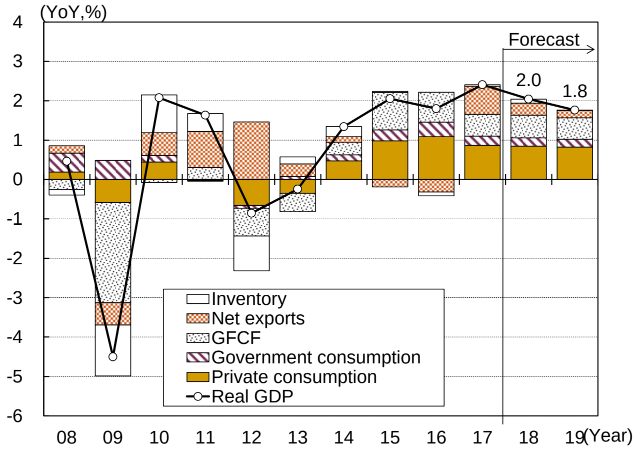
Table 1: Real GDP Growth Rates in Major European Countries

(YoY,%)

	2016			2017				2018	
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6
Eurozone	0.3	0.4	0.8	0.6	0.7	0.7	0.7	0.4	0.4
Germany	0.4	0.2	0.4	1.1	0.5	0.6	0.5	0.4	0.5
France	-0.2	0.2	0.6	0.8	0.6	0.7	0.7	0.2	0.2
Italy	0.1	0.2	0.5	0.5	0.4	0.3	0.3	0.3	0.2
Spain	0.8	0.7	0.7	0.8	0.9	0.7	0.7	0.7	0.6
Portugal	0.2	1.2	0.7	0.7	0.3	0.6	0.7	0.4	0.5
Greece	-0.3	0.5	-0.3	0.4	0.8	0.5	0.2	0.8	-

Source: Eurostat, MUFG Bank Economic Research Office

Chart 1: Eurozone Real GDP Forecast

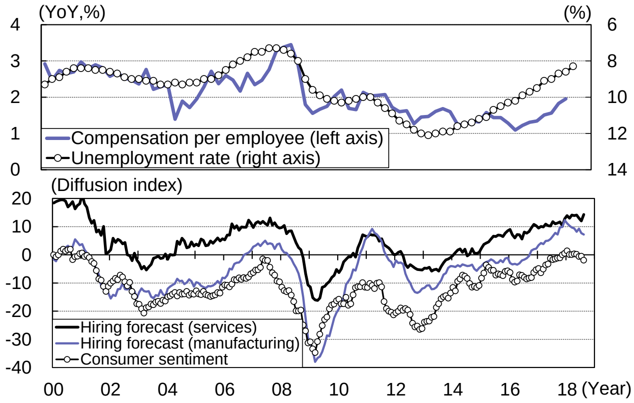


Source: Eurostat, MUFG Bank Economic Research Office

(2) Key Points of the Outlook

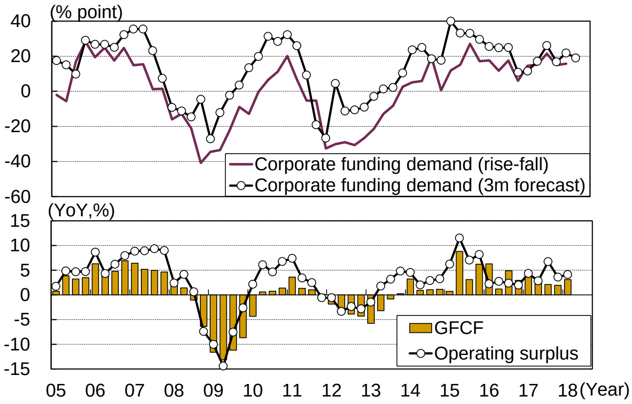
Employment and income conditions continue to improve, and the unemployment rate is approaching pre-global financial crisis (GFC) lows (Chart 2). Consumer sentiment remains healthy in line with corporate employment expectations, meaning that increasing wages are likely to continue to support expansion in private consumption, contributing to economic stability. Though pent up demand is subsiding, based on increasing corporate earnings and robust corporate funding demand, capital expenditure looks likely to rise (Chart 3).

Chart 2: Eurozone Unemployment rate, Employee Compensation, Consumer Sentiment, Hiring Forecast



Source: European Commission, Eurostat, ECB, MUFG Bank Economic Research Office

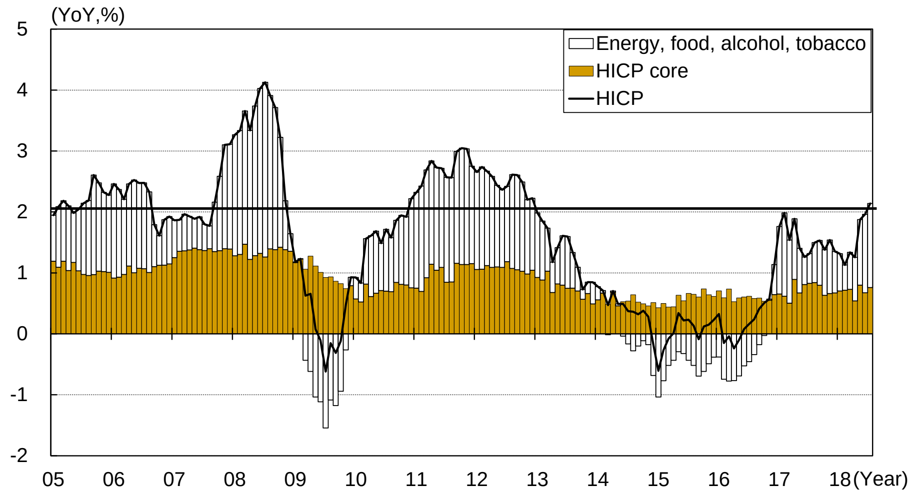
Chart 3: Eurozone Corporate Funding Demand, GFCF, Operating Surplus



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

At the Governing Council meeting in June, the European Central Bank (ECB) decided to terminate asset purchases by the end of the year. On interest rates, it indicated that they would remain at the current level "at least through the summer of 2019". Though consumer price index (CPI) inflation has exceeded the ECB target of "just below 2%", this is largely due to high oil prices, and core inflation (excluding energy, food, alcohol, and tobacco) remains sluggish (Chart 4). In this context, the deposit facility rate is likely to be raised (from -0.4 to -0.2%) in September 2019, just before Draghi retires from the presidency of the ECB. As ECB's exit strategy is expected to begin in earnest under the new ECB president in November 2019, it is important to keep a close eye on the selection of Draghi's successor.

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



Source: Eurostat, MUFG Bank Economic Research Office

2. UK

The UK economy continues to see moderate growth. Though Q2 real GDP growth lacked strength at 0.4% QoQ, it nonetheless was an improvement from Q1 growth which was limited to 0.2% QoQ under the influence of a cold snap.

The economic forecast for the UK is strongly dependent on the outcome of Brexit negotiations. In July, the UK government published a white paper outlining their negotiating stance, which suggested willingness to compromise with the EU. However, this did not result in a breakthrough in negotiations. A number of cabinet ministers have alluded to the possibility of a ‘Brexit cliff-edge’ and with opposition from hard-Brexiters escalating, there is little room for optimism over the context in which negotiations take place. Though its consequences would depend on its foreseeability, there are fears that a ‘Brexit cliff-edge’ scenario could destabilise financial markets, and disrupt supply chains, putting considerable downward pressure on the UK economy (Table 2).

However, assuming that the UK is able to avoid a ‘Brexit cliff-edge’, the UK economy is expected to see continued moderate expansion in line with potential growth. Real GDP growth is expected at 1.4% YoY for 2018, and 1.5% for 2019.

In terms of private consumption, the pace of growth is likely to weaken due to the fact that growth in consumer loans (which had supported household spending until now) has started to slow. However, the unemployment rate for Q2 fell to around a 43 year low of 4%, and an increase in wage growth is expected to follow. Inflationary pressure that had resulted from the depreciation of the pound into early 2017 is weakening, which will push up real purchasing power. Capital expenditure is expected to continue to rise, in the context of factors such as tight capacity constraints. Since 2016, corporate investment intentions have remained low compared to capacity constraints. This suggests that Brexit-related uncertainty is weighing on investment (Chart 5). However, if negotiations with the EU go well, corporate investment intentions are likely to rise due to receding uncertainty.

Table 2: Ongoing Issues Regarding Brexit

1. Informal summit on 20th September

Brexit to be discussed. Unless both sides are able to reach a compromise on the future relationship between the EU and UK, fears of a 'Brexit cliff-edge' will surge.

2. Around EU Summit on 18-19 October

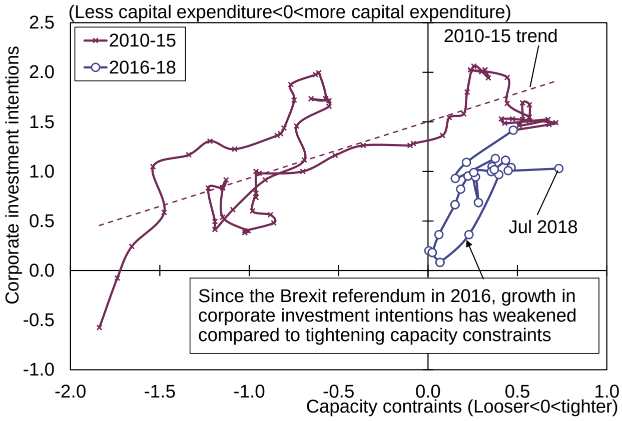
This is the deadline for substantial progress on the negotiation of the withdrawal agreement. Unless an agreement is made on all aspects of the negotiation, there are fears that the provisional agreement for a transitional period will become void.

3. The parliamentary vote on the withdrawal agreement

If the UK and EU reach an agreement, a vote on it will be held in parliament. The UK's ruling Conservative party does not have a majority in the house of commons, and there is a possibility of a rebellion among hard-Brexiters, meaning that the outcome of any such vote is unclear. If the agreement is rejected, political instability will increase, as will the risk of a 'Brexit cliff-edge'.

Source: Various sources, MUFG Bank Economic Research Office

Chart 5: UK Corporate Investment Intentions and Capacity Contraints

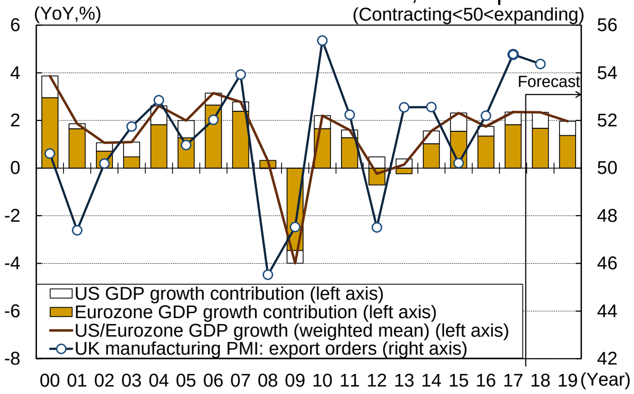


Source: Bank of England, MUFG Bank Economic Research Office

While the US and the Eurozone - the UK's major export markets - are expected to maintain their robust economic growth, the pace of growth in 2019 is forecast to be somewhat more gradual than in 2018. Because of this, we expect UK export growth to also slow slightly, whilst continuing to support the economy. Although export orders, which are an indicator for future exports, have peaked, they remain high (Chart 6).

In terms of monetary policy, the policy rate was raised 25 basis points on 2nd August to 0.75% (Table 3). The Bank of England (BoE) has indicated that it will continue to gradually raise interest rates, as the macroeconomic balance of the economy is turning to excess demand. Assuming that the UK is able to achieve a Brexit deal and transition period (March 2019-end 2020), the next 25 basis point interest rate rise is expected in May 2019.

Chart 6: US/Eurozone GDP Growth, UK Export Orders



Note 1: "US/Eurozone GDP growth" weighted according to UK export data
Note 2: 2018 "UK manufacturing PMI: export orders" based Jan-Jul average
Source: ONS, Eurostat, US Department of Commerce, IHS Markit, MUFG Bank Economic Research Office

Table 3: Results of August Monetary Policy Meeting

The decision and its context
• To raise the policy rate by 25 basis points to 0.75% (9 in favour, 0 against) • The dip in growth in Q1 was temporary, and momentum has recovered in Q2. The labour market has continued to tighten, and unit labour cost growth has firmed. • The deflationary gap has effectively disappeared.
Economic forecast
• Real GDP growth is expected to average 1.75% into 2020, above potential growth (of around 1.5%). The supply-demand balance will to turn to an inflationary gap in late-2019. • Inflation will remain slightly above slightly above the BoE target of 2% in the near future, and is expected to reach 2% in 2020. • UK economic forecast is based on a smooth Brexit, but the reality could vary considerably depending on developments in the Brexit process.
Monetary policy forecast
• Future rate increases will be at a gradual pace and to a limited extent. • Financial markets expect rates to be raised by 25 basis points around once per year for the next few years. This is generally an appropriate pace to reduce the inflation rate to target level.

Source: Various sources, BoE, MUFG Bank Economic Research Office

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