The Outlook for European Economies

All eyes on Brexit as European economies remain stable supported mainly by domestic demand

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1. Eurozone

(1) Overview of the Eurozone Economy

Eurozone real GDP growth for Q3, at 0.2% quarter-on-quarter (QoQ), has slowed from Q2's 0.4% QoQ (Table 1). The breakdown by expenditure of this figure is yet to be published, but it seems that growth was heavily impacted by the drop in automotive production due to the sector's delayed reaction to the introduction in September of the Worldwide Harmonised Light Vehicle Test Procedure (WLTP). The impact of this was particularly strong in Germany, where real GDP saw negative growth (of -0.2%) for the first time in three and a half years. Having said this, it is clear from monthly indicators that the automotive sector is beginning to recover from this downturn. In the Eurozone as a whole, exports (which were healthy last year), have been losing momentum due to an earlier euro appreciation and the slowdown in exports towards China. Domestic demand on the other hand remains stable. Looking forward, private consumption is expected to continue to expand as labour conditions improve. Exports also have potential to grow in the context of moderate expansion in the global economy. Real GDP growth is forecast at 1.9% year-on-year (YoY) in 2018, and is expected to slow somewhat to 1.6% YoY in 2019 whilst keeping pace with potential growth (around 1.5% YoY) (Chart 1).

From a policy and political point of view, there are a number of risks that have the potential to cause a downturn in the economy, and uncertainty is on the rise. In terms of Italian fiscal issues, conflict between the EU and the Italian government over their draft budgetary plan is ongoing, and bond yields remain high due to alarm over fiscal deterioration. Concern is mounting that high bond yields could lead to a negative cycle of an increasing debt burden and fiscal deterioration. Whilst this is unlikely to cause major disruption to other southern European countries, it is a situation that merits close attention. There are also a number of other risks that should be monitored: 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 ‘no deal Brexit’ scenario, 2) Change in political and policy direction in Germany following the resignation of Angela Merkel as leader of the Christian Democratic Union (CDU), 3) The potential for negative effects on the economy of countries like Germany if US tariffs are imposed on the automotive sector.

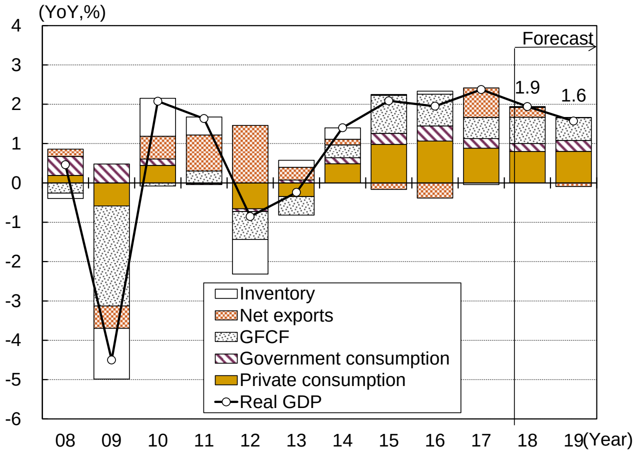
Table 1: Real GDP Growth Rates
in Major European Countries

(YoY, %)

	2016		2017				2018		
	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9
Eurozone	0.3	0.8	0.7	0.7	0.7	0.7	0.4	0.4	0.2
Germany	0.2	0.4	1.1	0.5	0.6	0.5	0.4	0.5	-0.2
France	0.2	0.6	0.8	0.6	0.6	0.7	0.2	0.2	0.4
Italy	0.3	0.5	0.5	0.3	0.4	0.3	0.3	0.2	0.0
Spain	0.8	0.6	0.8	0.9	0.6	0.7	0.6	0.6	0.6
Portugal	1.1	0.8	0.7	0.4	0.6	0.8	0.4	0.6	-
Greece	0.5	-0.3	0.4	0.9	0.5	0.2	0.9	0.2	-

Source: Eurostat, MUFG Bank Economic Research Office

Chart 1: Eurozone Real GDP Forecast

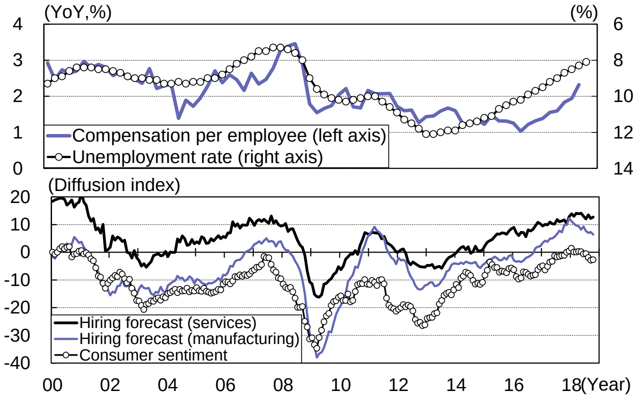


Source: Eurostat, MUFG Bank Economic Research Office

(2) Key Points of the Outlook

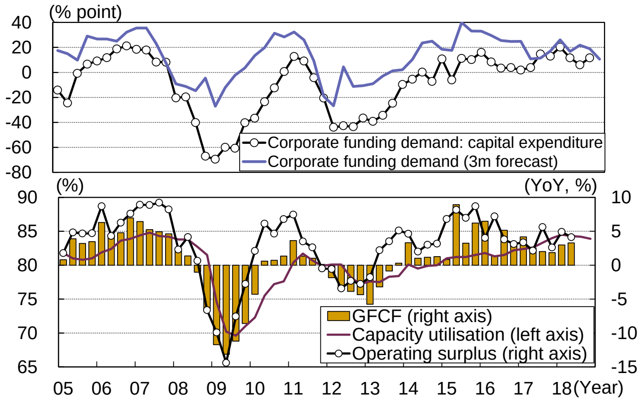
As Eurozone unemployment rates approach pre-global financial crisis lows, there has been an uptick in compensation per employee (Chart 2). Consumer sentiment remains broadly healthy in line with corporate employment expectations, meaning that improvement in employment and income conditions is likely to continue to support expansion in private consumption. Growth in capital expenditure is starting to slow, but it looks likely to remain steady on the back of continued increase in corporate earnings. This is reflected by robust corporate funding demand (Chart 3).

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



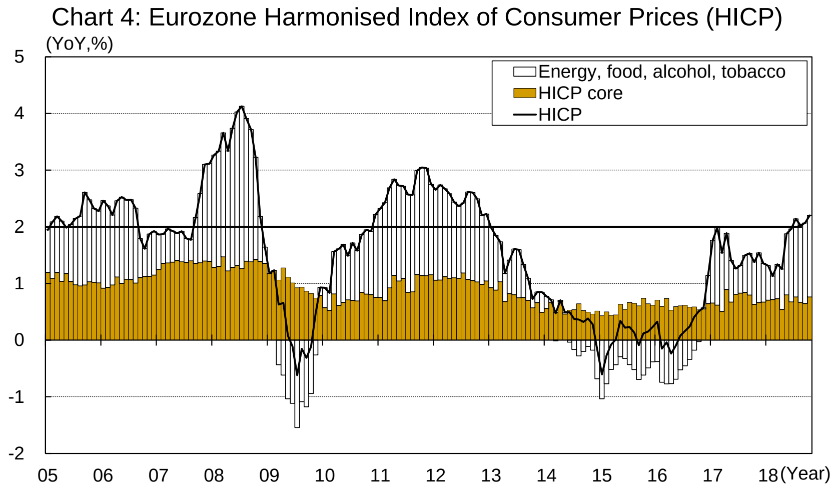
Source: European Commission, Eurostat, ECB
MUFG Bank Economic Research Office

Chart 3: Eurozone Corporate Funding Demand, GFCF, 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 Governing Council of the European Central Bank (ECB) reaffirmed at its October meeting its June decision to end net asset purchases by the end of the year and keep interest rates at their current level "at least through the summer of 2019". Though consumer price index (CPI) inflation has remained above the ECB target of "just below 2%" for 5 months straight, this has been largely due to high oil prices, and core inflation (excluding energy, food, alcohol and tobacco) has remained subdued around 1% YoY (Chart 4). In this context, the deposit facility rate is likely to be raised (from -0.4 to -0.2%) in autumn 2019, in other words just before Draghi retires from the presidency of the ECB. The ECB will proceed carefully with its exit strategy, paying due attention to risks that have potential to cause a downturn in the economy.

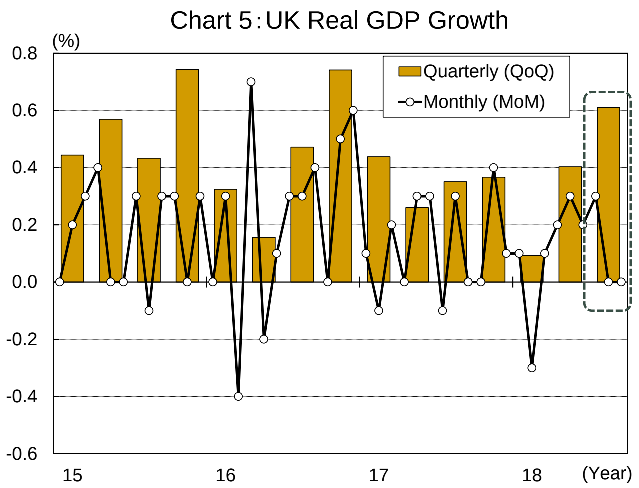


Source: Eurostat, MUFG Bank Economic Research Office

2. UK

The UK's real GDP growth rate was relatively high in Q3 at 0.6% QoQ. However, this can mainly be attributed to temporary effects due to warm summer weather (Chart 5). Based on the flat GDP growth observed in August and September, and October composite purchasing managers index (PMI) reaching a 27-month low, it looks likely that growth will slow accordingly in Q4. We judge from this that on average, the pace of growth remains moderate.

In terms of Brexit, the UK and the EU reached an agreement at the emergency EU summit on 25 November on the withdrawal agreement and political declaration on the future relationship between the UK and the EU. However the withdrawal agreement needs to be approved in the UK's House of Commons in order to come into effect, and there is currently no telling whether it will pass (Table 2). There are strong fears of a 'no deal Brexit' whereby the UK leaves the EU as scheduled on 29 March 2019, without entering into a transition period. This would mean that tariffs would immediately apply to trade between the UK and the EU.



Source: ONS, MUFG Bank Economic Research Office

Table 2: Key Points for the Future of Brexit

1. Vote on the withdrawal agreement in the House of Commons The withdrawal agreement must be voted through parliament in the UK and the EU. In the UK, the majority of opposition MPs as well as some members of the ruling conservatives oppose the deal, meaning that it is unlikely to pass. It is expected to pass the EU ratification process. **2. What happens if the withdrawal agreement is rejected by House of Commons?** This would inevitably lead to political confusion. There are a number of possible outcomes, including: renegotiation with the EU (although the EU position is that this option isn't available), prime ministerial resignation, a general election, or another referendum. There is a higher risk that an agreement is not reached by 29 March 2019 and a ‘no deal Brexit’ becomes reality. **3. Movement against Theresa May in the conservative party** Within the conservative party, the movement to submit no-confidence in the prime minister Theresa May is ongoing. The prime minister being toppled would lead to a political vacuum, heightening concern of a 'no deal Brexit'. There is also a risk that a hard-line Brexiter could ascend to the leadership.

Source: Various news sources, MUFG Bank Economic Research Office

In the case of a 'no deal Brexit', a recession in 2019 is likely to result from factors such as disruption to supply chains (Table 3). Both the main opposition Labour party and the secondary opposition Scottish National Party (SNP) oppose Theresa May's withdrawal agreement, but have made it clear that they would block a 'no deal Brexit'. The Labour party also claims that the UK should seek an extension to the negotiation period from the EU if the withdrawal bill is rejected in the House of Commons. There are some within the EU that agree that major political upheaval in the UK would be reason enough to extend the negotiation period. This means that at present, our main scenario is that a 'no deal Brexit' will be avoided either by political compromise between the Conservatives and their opposition, or by an extension to the negotiation period.

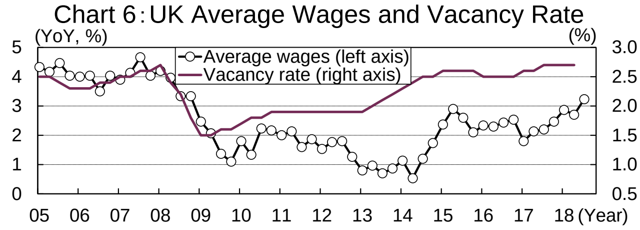
If the UK is able to avoid a 'no deal Brexit', we expect real GDP growth of 1.4% YoY in 2019, moderate growth in line with expectations for 2018 (of 1.3% YoY). Private consumption will be supported by increased wage growth and growth in employment (Chart 6). Whilst export demand is forecast to see a moderate slowdown, we also expect the Brexit related uncertainty that is currently weighing on capital expenditure to recede, meaning that capital expenditure that has been withheld can be implemented (Chart 7).

Table 3：'No deal Brexit' Scenarios

Scenario 1: Clean 'no deal'
Though the withdrawal agreement is rejected, the UK and the EU cooperate to reduce uncertainty, and the private sector prepares adequately for Brexit. The pound drops around 10% in value. Though import inflation is a drag on consumer spending, the monetary easing by Bank of England (BoE) provides some support for the economy. Real GDP growth for 2019 at -0.2% YoY.
Scenario 2: Messy 'no deal'
Major increase in uncertainty as relations between the EU and the UK deteriorate and are unable to agree on a strategy to deal with Brexit. Serious disruption to supply chains and the private sector is not adequately prepared for Brexit. The pound comes under considerable downward pressure, and the BoE is forced to raise interest rates. Import inflation and dropping sentiment combine with interest rate rises to result in a deeper recession than under a clean 'no deal'. Real GDP growth for 2019 at -1.8% YoY.

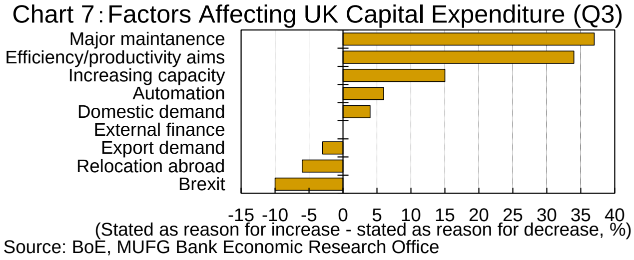
Source: MUFG Bank Economic Research Office

Chart 6：UK Average Wages and Vacancy Rate



Source: ONS, Eurostat, MUFG Bank Economic Research Office

Chart 7：Factors Affecting UK Capital Expenditure (Q3)



Source: BoE, MUFG Bank Economic Research Office

In terms of prices, October's inflation rate was 2.4% YoY. This remains higher than the Bank of England (BoE) target of 2% but it has slowed from the rates around 3% YoY recorded in early 2018. Looking forward, whilst there will be some effect from easing inflationary pressure from imports and the recent drop in oil prices, inflation is likely to remain high due to acceleration in wage growth.

Inflation rates are expected to remain above 2% YoY until late 2019, and the BoE is expected to continue to gradually and incrementally raise interest rates. It is likely that the high levels of uncertainty over Brexit and the political situation in the UK will continue at least until the UK's scheduled departure from the EU on 29 March 2019, meaning that for the time being interest rates are expected to remain unchanged at 0.75%. Assuming that the UK is able to avoid Brexit related confusion and enter its transition period as planned (lasting until 2020), we expect the next interest rate rise of 25 basis points to take place in May 2019.

3. Russia

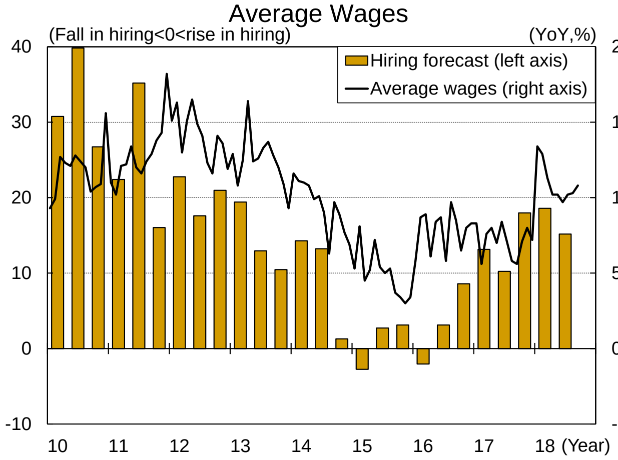
Economic growth in Russia has been slowing somewhat since mid-2018. Real GDP growth for Q3 was 1.3% YoY, lower than Q2's 1.9% YoY. The rouble depreciated due in part to the strengthening of US sanctions on Russia (in April and August 2018), which lead to rising inflation rates. The rise in inflation rates has been a drag on private consumption. The central bank has until recently supported the economy through gradual interest rate cuts, but is now changing track on monetary easing. In September, the central bank raised interest rates by 25 basis points as a reaction to high inflation risk. So far, the Russian economy has avoided a further slowdown, and October's composite purchasing managers index (PMI) was 55.8, an improvement on the Q3 average of 52.4. The unemployment rate has improved to around 4%, a low last recorded in the early 1990s, and the economy is being bolstered by healthy employment and income conditions.

Looking forward, we expect our main scenario to remain unchanged: moderate growth will continue to be supported by healthy employment and income conditions. Hiring forecasts are robust, and we expect continued increase in employment, with wage growth likely to be relatively high in the context of low unemployment rates (Chart 8). The investment plan announced by the government in May 2018 is also expected to support economic expansion. Under the investment plan, RUB 3 trillion (3.3% of nominal GDP) in investment is expected to made by 2024, mainly in transport infrastructure. Around two thirds of this investment is planned to be implemented by 2020. On the other hand, there are a number of factors with potential to negatively affect the Russian economy. These include: the effect of dropping oil prices[1] on export revenues and on investment in the energy sector (Chart 9), the VAT rise due in January 2019 (from 18% to 20%), rising inflation rates, a retreat in growth following the FIFA world cup (June-July 2018). However, it is unlikely that any of these would have a major negative impact on the economy.

[1] MUFG Bank Economic Research Office predicts that WTI prices will average at $65USD per barrel in 2018, and $59USD per barrel in 2019. Please refer to our “Outlook for Oil Prices” for further details.

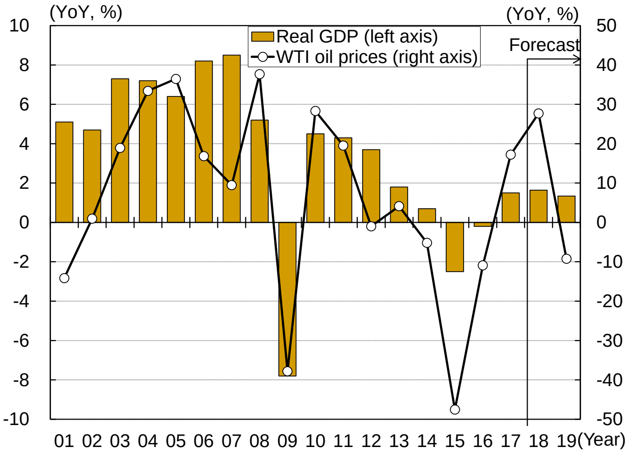
We expect real GDP growth in 2019 at 1.3% YoY, which, though lower than our 2018 forecast of 1.6%, will mark a third consecutive year of positive growth.

Chart 8: Russian Corporate Hiring Forecast, Average Wages



Source: IHS Markit, MUFG Bank Economic Research Office

Chart 9: Russian Real GDP Growth and Oil Prices



Source: Rosstat, Bloomberg, MUFG Bank Economic Research Office

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