The Outlook for European Economies

Steady growth centred on private consumption to continue even as economic slowdown sets in

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1. Eurozone

(1) Overview of the Eurozone Economy

The slowdown in the Eurozone economy has intensified since the latter half of 2018. Real GDP growth in Q4 2018 was just 0.2% quarter-on-quarter (QoQ) (Chart 1). On a national level, while Germany narrowly avoided a recession in Q4 with real GDP growth of 0.0% QoQ, the pace of recovery was affected by factors such as the delayed reaction to new automotive regulation (discussed below). In France, private consumption slumped due to the effects of protests against the government’s economic reforms. Italy has seen two consecutive quarters of negative growth caused by rises in long-term interest rates and a drop in sentiment caused by fiscal instability.

Political and policy uncertainty is likely to remain high in 2019, given both the UK's troubled Brexit negotiations and lingering trade tensions between the US and China. Having said this, the approximate trajectory of these two issues is likely to become clear in the first half of this year. Protests in France are also in the process of settling down. Corporate sentiment (which has been notably weak) is set to improve as uncertainty dispels to some extent.

Looking forward, the Eurozone as a whole is expected to see reduced export growth in the context of the economic slowdown in major trading partners like China. However, private consumption will remain steady against a backdrop of continued improvement in employment and income conditions. Government expenditure is also expected to expand in major Eurozone countries. Overall, growth will remain steady, supported by private consumption. We forecast real GDP growth for 2019 at 1.4% year-on-year (YoY), slightly below potential growth (around 1.5% YoY) (Chart 1).

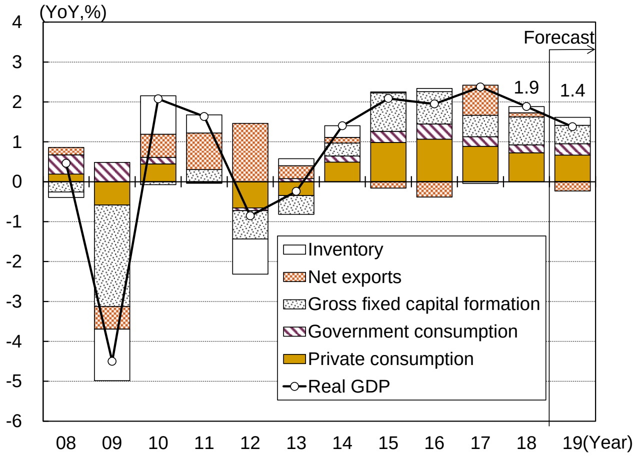
Chart 1: Real GDP Growth Rates in Major Eurozone Countries

(YoY,%)

	2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Eurozone	0.7	0.7	0.7	0.7	0.4	0.4	0.2	0.2
Germany	1.1	0.5	0.6	0.5	0.4	0.5	-0.2	0.0
France	0.8	0.6	0.6	0.7	0.2	0.2	0.3	0.3
Italy	0.5	0.3	0.4	0.3	0.3	0.1	-0.1	-0.2
Spain	0.8	0.9	0.6	0.7	0.6	0.6	0.6	0.7
Portugal	0.7	0.4	0.6	0.8	0.4	0.6	0.3	-
Greece	0.1	1.3	0.5	0.2	0.5	0.4	1.0	-

Source: Eurostat, MUFG Bank Economic Research Office

Chart 1: Eurozone Real GDP Growth Forecast



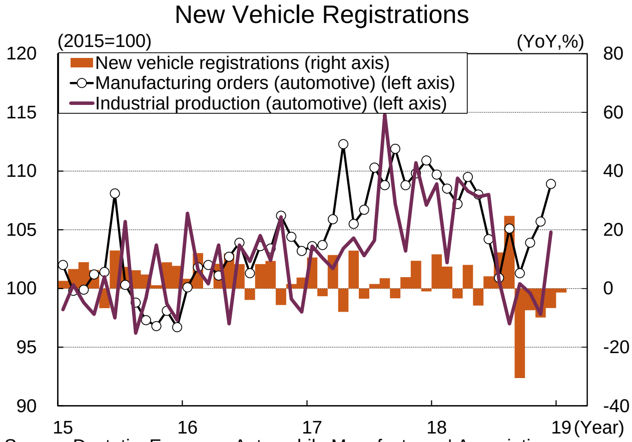
Source: Eurostat, MUFG Bank Economic Research Office

(2) Key Points of the Outlook

Industrial production in the Eurozone has declined considerably since autumn 2018. This is largely due to the sudden drop in automotive production owing to the sector's delayed reaction to the introduction of the Worldwide Harmonised Light Vehicle Test Procedure (WLTP) in September. In Germany, the largest economy in the region, the car sales are now recovering after the pre-legislation rush and subsequent drop in sales associated with the WLTP (Chart 2). In the meantime, manufacturers have adjusted their production processes, and automotive orders and production have also clearly improved. The automotive sector has a particularly pronounced ripple effect on other industries, and its recovery could be a strong factor in preventing the bottom falling out of the economy. On the other hand, from a demand perspective, a slowdown in exports looks to be inevitable. Having said this, in terms of consumer dynamics, growth in compensation per employee is accelerating as unemployment rates fall to pre-financial crisis lows (Chart 3). Improvement in employment and income conditions is expected to continue to support expansion in consumption, and help to maintain steady growth.

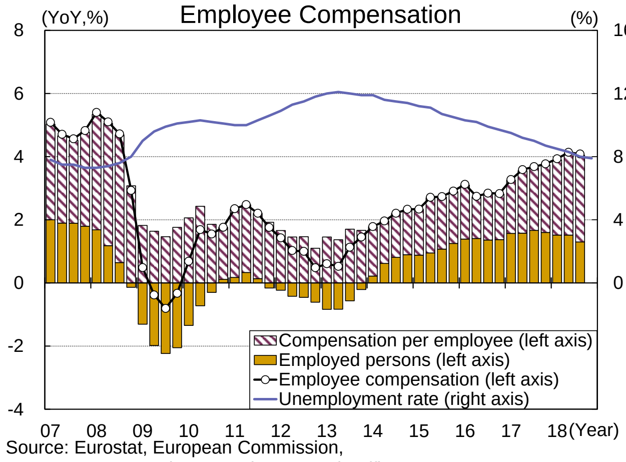
Nevertheless, the outcome of political and policy-related events including Brexit and the European Parliament elections (in May) will need to be closely monitored.

Chart 2: German Autmotive Orders, Production, New Vehicle Registrations



Source: Destatis, European Automobile Manufacturers' Association
MUFG Bank Economic Research Office

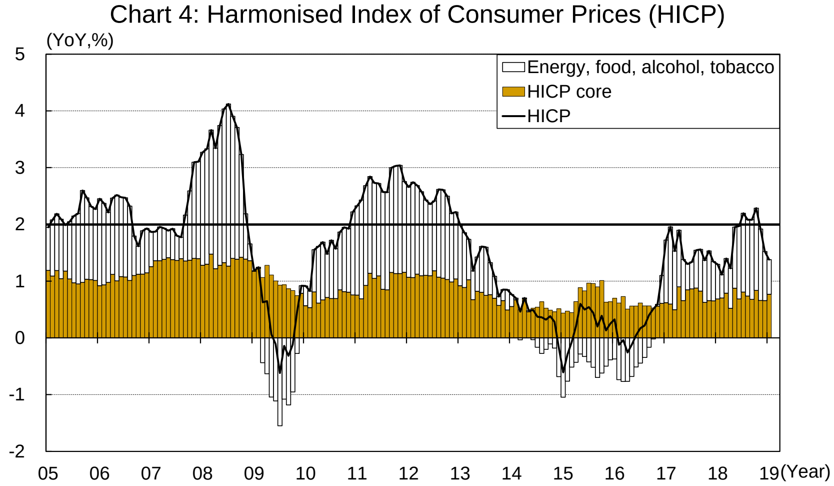
Chart 3: Eurozone Unemployment Rate, Employee Compensation



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

In terms of monetary policy, the European Central Bank (ECB) ended net asset purchases in late 2018. However, at its January meeting, the Governing Council made a downward revision to its growth risk assessment following the slowdown in economic momentum in the Eurozone amid growth in internal and external sources of uncertainty. Consumer price index (CPI) inflation has been below the ECB target of "just below 2%" since November 2018. Lower inflation reflects the drop in oil prices, though core inflation (excluding energy, food, alcohol, and tobacco) also remains sluggish (Chart 4). Policy rate normalisation – starting with the deposit facility rate which will be raised from -0.40% to -0.20% – is likely to be delayed beyond our original forecast of autumn 2019, until after December 2019.

Chart 4: Harmonised Index of Consumer Prices (HICP)

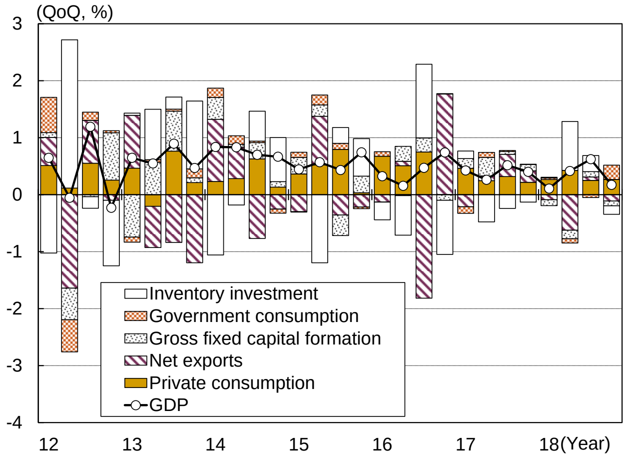


Source: Eurostat, MUFG Bank Economic Research Office

2. UK

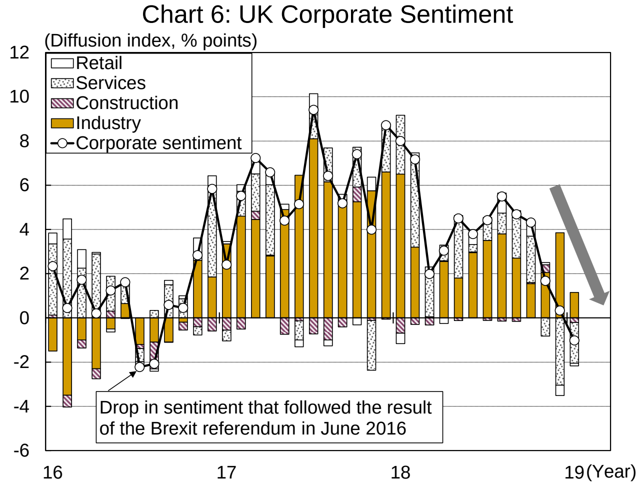
In Q4, real GDP growth was 0.2% QoQ, a marked slowdown from Q3's 0.6% QoQ (Chart 5). Private consumption remained steady at 0.4% QoQ, but gross fixed capital formation turned negative at -0.5% QoQ and dragged on growth. In terms of the components of gross fixed capital formation, business investment fell by -1.4% QoQ, the biggest drop since Q1 2016. This fall in business investment could be framed in the context of the deterioration in corporate sentiment, linked to fears over a global slowdown and the UK's troubled Brexit process. Alternatively, corporates could be taking a wait-and-see approach to investment until the outcomes of Brexit and US-China trade negotiations become clear (Chart 6).

Chart 5: UK Real GDP Growth



Source: ONS, MUFG Bank Economic Research Office

Chart 6: UK Corporate Sentiment



Source: European Commission, MUFG Bank Economic Research Office

In Brexit negotiations, the UK government and the EU reached a Withdrawal Agreement in November 2018. However, UK parliament is currently deadlocked over the ratification required for the agreement to come into force. As the planned Brexit date of 29 March draws ever closer, a short-term extension to Article 50 has come into play. On 26 February, Theresa May revealed that if the withdrawal agreement is rejected in parliament by 12 March, and parliament also vote against a 'no-deal Brexit', she would hold a vote on the extension of Article 50 (Table 2). Given that Theresa May has limited this to a single extension lasting until the end of June, it is hard to say whether this will allow enough time to break the deadlock. We must therefore monitor the risk that the UK could still be left with no option but a 'no-deal Brexit' after a short extension. This would result in an economic recession owing to issues such as supply chain disruption.

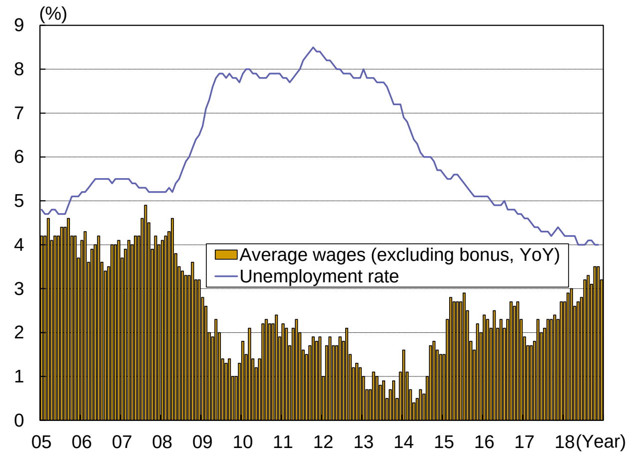
Turning to underlying economic trends in the UK, though factors like the deterioration in corporate sentiment discussed above have proved a drag on growth, the referendum result has not led to any clear economic deterioration so far. Employment and income conditions are particularly healthy, and the unemployment rate, at 4%, has recovered to a level lower than the natural unemployment rate of 4.25% estimated by the Bank of England (BoE) (Chart 7). Wage growth is accelerating in the context of labour market tightness, and is expected to support household spending. Once future uncertainty recedes, capital expenditure is expected to recover, and there is scope for moderate annual GDP growth in the region of 1.0-1.5% YoY.

Table 2: Key Dates for UK EU Withdrawal

By 12 March	Vote (1) on EU Withdrawal Agreement
By 13 March	Vote (2) on 'no deal Brexit' if EU Withdrawal Agreement rejected in vote (1)
By 14 March	Vote (3) on extension to Article 50 if 'no deal Brexit' rejected in vote (2)
21-22 March	EU Summit. UK may discuss extension to Article 50 with other EU countries if approved in vote (3).
29 March	Current EU exit date (without Article 50 extension)
20-21 June	EU Summit
30 June	EU exit date envisaged by PM Theresa May under extension to Article 50

Source: Various sources, MUFG Bank Economic Research Office

Chart 7: UK Unemployment Rate and Average



Source: ONS, BoE, MUFG Bank Economic Research Office

In terms of prices, CPI inflation fell below the BoE's target of 2% YoY for the first time in two years in January, at 1.8% YoY (down from 2.1% YoY in December). This slowdown in inflation can primarily be attributed to lower oil prices, with core inflation unchanged from December at 1.9% YoY. Looking forward, it is likely that acceleration in wage growth will put upward pressure on price growth.

The BoE has raised its policy rates to 0.75% (+0.25% in November 2017, +0.25% in August 2018). Fundamentally, the BoE plans to maintain its current policy to raise interest rates at a gradual pace and to a limited extent in order to control inflation. This is based on the judgement that the macroeconomic balance is shifting towards excess demand. However, the current policy is dependent on the UK achieving an orderly exit from the EU. Because of this, further interest rate rises are likely to be delayed until after the issues with the Withdrawal Agreement have been solved, and future uncertainty has receded.

In parliament on 26 February, Governor Mark Carney said that the BoE would be “more likely than not” to cut interest rates to support the economy in a 'no-deal Brexit' scenario. The BoE has previously pointed to the likelihood of economic fallout resulting from 'no-deal Brexit', but had until now kept both interest rate rises and cuts on the table due to the potential for a rise in inflationary pressure from import shortages and sterling depreciation. This marks a step change in the BoE's outlook.

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