Steady growth centred on private consumption to continue despite extra-regional concerns

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1. Eurozone

(1) Overview of the Eurozone Economy

After the slowdown in the Eurozone economy intensified in the latter half of 2018 due to the effects of the introduction of the Worldwide Harmonised Light Vehicle Test Procedure (WLTP) and the slowdown in external economies, real GDP growth improved in Q1 2019, at 0.4% quarter-on-quarter (QoQ). This improvement can partially be attributed to the peaking of the effects of the introduction of the WLTP on production processes in the automotive sector. On a national level, Germany saw a second consecutive quarter of growth, with Q1 growth at 0.4% QoQ. This was supported by robust private consumption and construction. France also saw real GDP growth of 0.3% QoQ amid expansion in private consumption which has accelerated as the effects of protests against economic reforms have worn off. After three quarters of negative growth, Italy exited recession with growth of 0.1% QoQ, with net exports making a positive contribution as well as increased production in major sectors (Table 1). As we discuss in detail below, there remain a variety sources of concern to the Eurozone both within and outside of Europe. Fundamentally however, domestic demand is expected to remain robust centred on consumer spending supported by healthy employment and income conditions. Government expenditure is also expected to expand in major countries. In 2019, we expect growth to slow to 1.3% year-on-year (YoY), reflecting the Eurozone's poor starting position at the start of the year. Having said this, we expect the pace of GDP growth to pick back up to around potential (around 1.5%) with growth of 1.5% YoY in 2020 (Chart 1).

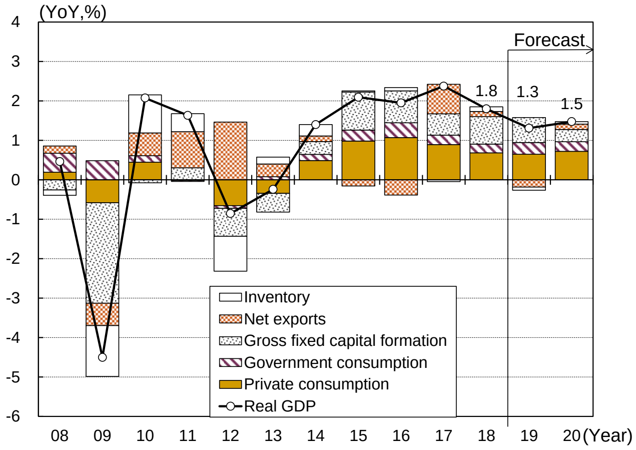
Table 1: Real GDP Growth in Major European Countries

(YoY, %)

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2018 (actual)	2019 (forecast)	2020 (forecast)
Eurozone	0.4	0.4	0.1	0.2	0.4	1.8	1.3	1.5
Germany	0.4	0.5	-0.2	0.0	0.4	1.5	1.1	1.5
France	0.3	0.2	0.3	0.4	0.3	1.7	1.3	1.4
Italy	0.1	0.1	-0.1	-0.1	0.1	0.8	0.3	0.7
UK	0.1	0.4	0.7	0.2	0.5	1.4	1.3	1.3

Source Eurostat, MUFG Bank Economic Research Office

Chart 1: Eurozone Real GDP Growth Forecast



Source: Eurostat, MUFG Bank Economic Research Office

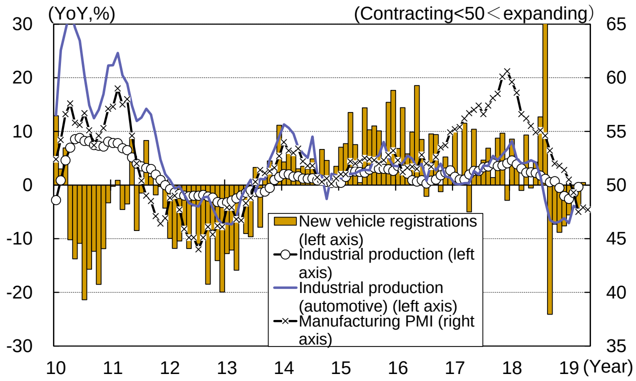
(2) Key Points of the Outlook

One reason to be optimistic is the fact that industrial production is currently showing signs of recovery. This is because the temporary effects of the drop in automotive production which resulted from the introduction of the WLTP have worn off (Chart 2). In terms of demand, the slowdown in exports is expected to continue for the time being, but in Europe domestic demand tends to have a stronger influence over the economy as a whole. Looking at the environment around private consumption (which makes up the largest component of demand), compensation per employee remains high as unemployment rates have fallen to pre-global financial crisis (GFC) lows. Based on the fact that consumer sentiment is still towards the upper end of the range for the last 10 years, we expect that healthy employment and income conditions will continue to support private consumption and therefore economic recovery into next year (Chart 3). Capital expenditure is also expected to remain stable given high capacity utilisation rates and the fact that the fund-raising environment remains accommodative.

However, future uncertainty persists over political and policy issues such as US-China trade frictions and unresolved Brexit negotiations. This future uncertainty is a factor in the slump in external demand that started mid-2018. There are fears that external demand could deteriorate further in the case of a 'no-deal Brexit' or if there is further escalation in the US-China conflict. The European Parliament elections held on 23-26 May 2019 marked the first time since the introduction of the proportional representation system that two largest political groups in the European parliament: the European People's Party (EPP) and the Progressive Alliance of Socialists and Democrats (S&D) failed to win a majority of seats. This being said, a majority can be achieved through cooperation with the third largest group in the European Parliament, the Alliance of Liberals and Democrats for Europe (ALDE), meaning that fears over the potential radicalisation of the extreme policies of Eurosceptic parties have retreated. Nevertheless, looking at the national results there are a number of countries where Eurosceptic parties came first in the polls (Le Pen's National Rally party in France, Salvini's League party in Italy, and the single issue Brexit party in the UK). We cannot deny that the results of the European Parliament Elections have the potential to have a major impact on the future political direction of individual EU member states. Autumn this year will see a number of vacancies appear at the top of the EU, including the presidencies of the European Commission, European Council, and European Central Bank (ECB).There is already conflict between Germany and France over the selection of the next president of the European Commission. All eyes will be on the way that this debate develops given the new pattern of groupings in the

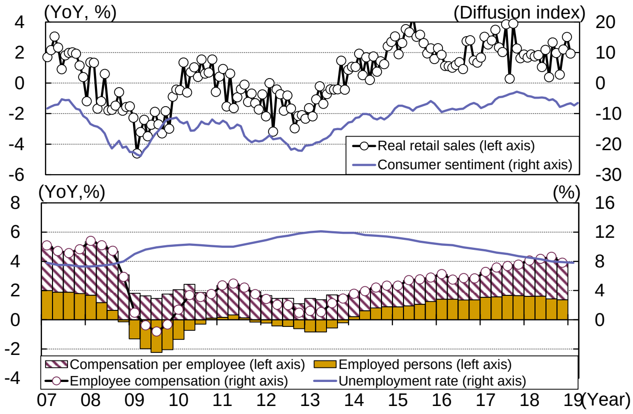
European Parliament. Following on from this, we advise caution over the outcomes of political and policy events both within and outside the region.

Chart 2: Eurozone Industrial Production, New Car Registrations, Manufacturing PMI



Note: Industrial production is 3 month moving average
Source: Eurostat, European Automobile Manufacturers' Association IHS Markit, MUFG Bank Economic Research Office

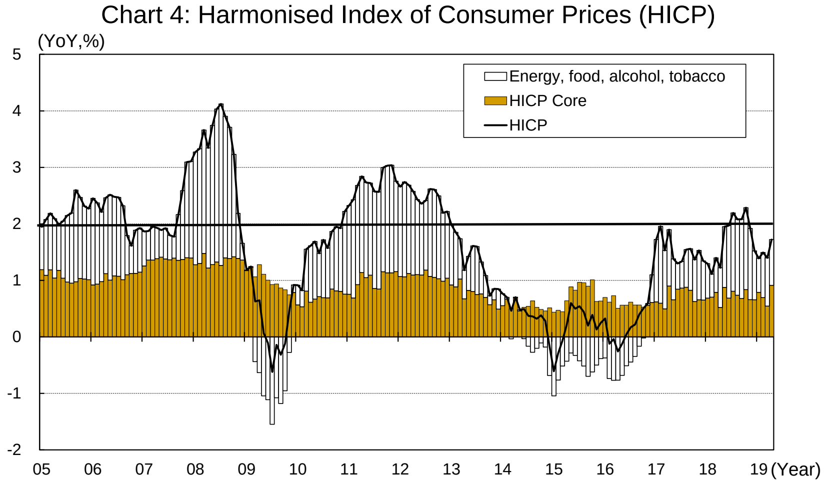
Chart 3：Eurozone Real Retail Sales, Consumer Sentiment, Unemployment, Employee Conpensation



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

In terms of monetary policy, the Governing Council of the ECB changed its forward guidance on policy rates at its March 7 meeting. The ECB announced that it would delay raising rates, keeping them unchanged 'through summer 2019' to 'through the end of 2019'. Consumer price inflation (CPI) has been under the ECB target of "just below 2%" since November 2018, mainly due to the drop in oil prices, and core inflation (excluding energy, food, alcohol and tobacco) also remains sluggish (Chart 4). This means that it is difficult to foresee any major change in monetary policy in the near future. Until last year, certain observers expected the current president of the ECB Mario Draghi to set out a path for interest rate hikes before the curtain falls on his term. However this possibility seems now to have largely evaporated. Following on from this, we must remain aware of discussions on the policy programme and its schedule until the structure of the EU and ECB's new leadership teams is established. At present, there is a considerable difference of opinion in Germany and southern European countries on the current policies of monetary easing. In any case, we expect that policy rate normalisation – starting with the deposit facility rate which will be raised from -0.40% to -0.20% – may now need to be delayed until mid-2020. This would allow time for the new leadership of the ECB and the EU to gain the trust of the market, amid a likely continuation of moderate economic growth in the Eurozone.

Chart 4: Harmonised Index of Consumer Prices (HICP)



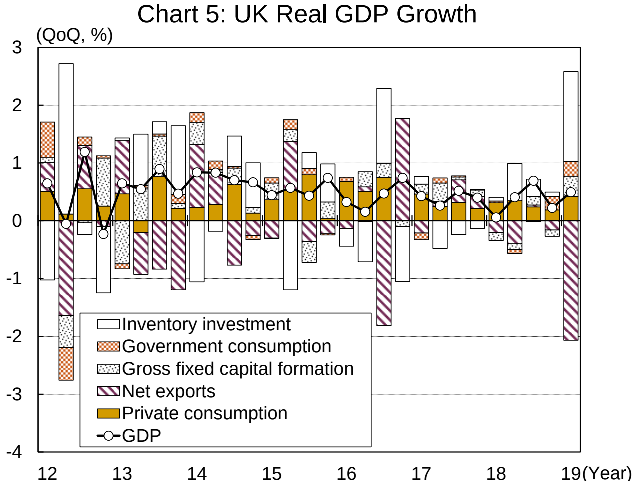
Source: Eurostat, MUFG Bank Economic Research Office

2. UK

In Q1, real GDP growth was 0.5% QoQ, an improvement from Q4's 0.2% QoQ (Chart 5). However, this is likely to be largely due to temporary factors. In terms of individual components, growth in government investment (which is a sub-component of gross fixed capital formation) has shot up (from 0.5% QoQ in Q4 to 8.1% in Q1). Stockpiling by households in preparation for a 'no-deal Brexit' also boosted private consumption (from 0.3% QoQ in Q4 to 0.6% QoQ in Q1).

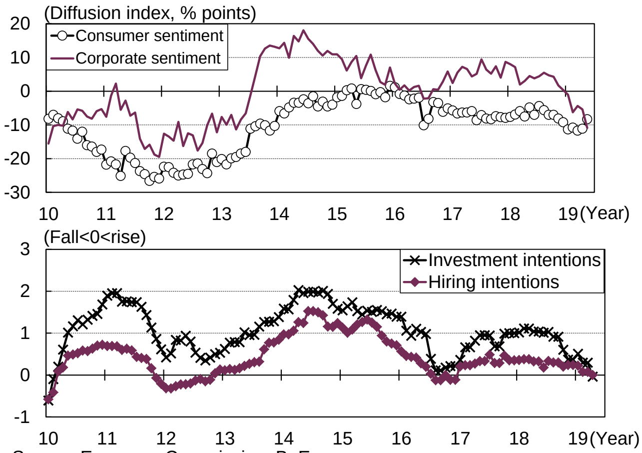
Consumer and corporate sentiment had deteriorated into April as fears over a 'no-deal Brexit' increased, and on the whole, economic headwinds seem to be rising (Chart 6). Corporate capital expenditure has seen investment intentions become increasingly muted, with corporates increasingly adopting a wait-and-see approach to investment since Brexit negotiations reached a deadlock late last year. Recent real GDP growth figures reveal that business investment grew by 0.5% QoQ in Q1. This followed four consecutive quarters of negative growth ending in Q4 2018. Based on the current cautious approach to investment, it is logical to assume that the Q1 recovery in business investment is just a temporary bounce back, and that the overall trend is one of weakness. Turning to employment and income conditions, the situation currently resembles that in the EU, with unemployment at 3.8% in Q1 (its lowest level since 1974) and wage growth accelerating moderately. However, given the fact that corporate hiring intentions have been affected by the specific circumstances of the ongoing Brexit debate, it is hard to say that the UK is on firm footing in this respect.

Chart 5: UK Real GDP Growth



Source: ONS, MUFG Bank Economic Research Office

Chart 6: UK Corporate and Consumer Sentiment



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

Brexit will hold a great deal of sway over the future direction of the UK economy. At the moment, it seems likely that future uncertainty will persist for now as the process for ratifying the Brexit withdrawal agreement remains deadlocked in parliament (Table 2). The original deadline for ratifying the withdrawal agreement has been extended from 29 March 2019 to 31 October 2019, but there is no telling if parliament will approve the deal. Theresa May was forced to announce her resignation (on 24 May) after members of her own party rebelled against her plan to link a fourth vote on the withdrawal agreement to a second referendum. If a Brexit hardliner is chosen as the next prime minister, the likelihood of a 'no-deal Brexit' is likely to increase further.

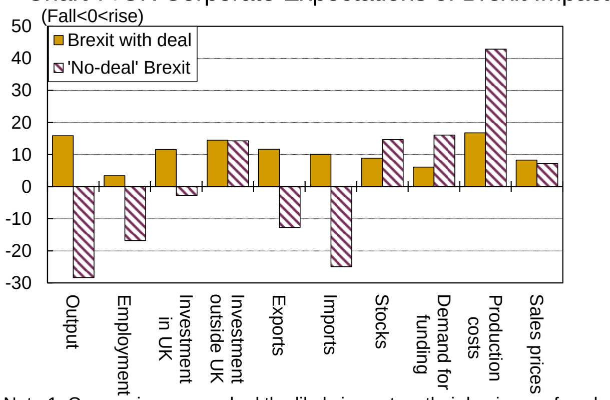
Given these circumstances, it is inevitable that future uncertainty over Brexit will continue to drag on the UK economy. Economic developments post-Brexit could differ substantially according to the final decision on Brexit policy. As we saw in April, the leaders of both the EU and the UK seem keen to avoid a 'no-deal Brexit'. As long as leaders ultimately avoid a ‘no-deal’ outcome the UK should achieve moderate growth of 1.0-1.5% YoY in 2019 and 2020 (if a deal is ratified, or in the case of no Brexit, we foresee a boost from improved corporate investment and hiring intentions). On the other hand, UK corporates expect that a 'no-deal Brexit' would result in a fall in output, employment, investment in the UK, and exports, in which case it is likely that the UK economy would fall into recession (Chart 7).

Table 2: Timeline of Brexit Related Developments

2018	
13 Nov	UK and EU negotiating teams agree upon withdrawal agreement. Ratification by both UK and EU parliament needed in order for it to come into effect
2019	
15 Jan	Withdrawal agreement rejected in UK parliament (first time). Both Conservative allies the Democratic Unionist Party (DUP) and Brexit hardliners within the ruling Conservative Party object to provisions to avoid a hard border in North Ireland (Irish backstop)
12 Mar	Withdrawal agreement rejected in UK parliament (second time)
21-22 Mar	At an EU summit, the EU and UK agree to extend date of EU withdrawal from 29 Mar: ①Extension to 22 May if withdrawal agreement approved ② Extension until 12 April if withdrawal agreement not approved
29 Mar	Withdrawal agreement rejected in UK parliament (third time)
10 Apr	At an emergency EU Summit, the deadline for UK to approve withdrawal agreement is extended to 31 October 2019
24 May	Theresa May announces her resignation
July	Selection of new Conservative Party leader (PM)
31 Oct	Deadline to ratify withdrawal agreement in UK parliament. Without a further extension, the UK will leave the EU with 'no-deal' on 1 Nov

Source: Various news sources, MUFG Bank Economic Research Office

Chart 7：UK Corporate Expectations of Brexit Impact



Note 1: Companies were asked the likely impact on their business of each scenario relative to the last 12 months
Note 2: Survey date：2/3/2019-8/4/2019
Source: BoE, MUFG Bank Economic Research Office

In terms of prices, CPI inflation remains high around the BoE target of 2% YoY (2.1% YoY in April). As long as the UK is able to avoid major Brexit-related disruption, the BoE expects the balance of supply and demand to turn towards excess demand. Because of this, as long as the UK exits the EU with a deal (i.e. if the withdrawal agreement is approved in parliament) the BoE is expected to resume raising policy rates to control inflation (policy rates were raised 0.25% in November 2017 and in August 2018). On the other hand, in the case of a 'no-deal' Brexit, the BoE could conceivably cut rates.

3. Russia

Real GDP growth in Q1 was 0.5% YoY, a marked slowdown from Q4's 2.7% YoY growth, and a five quarterly low. The breakdown by demand component is yet to be published, but based on real retail sales (down from 2.4% YoY in Q4 to 1.8% YoY in Q1), it seems likely that a slowdown in private consumption was influential here (Chart 8). Real wages have recently been suppressed by a combination of temporary factors affecting both nominal wages and inflation. This is likely to be feeding into weakness in private consumption. Growth in nominal wages has dropped as a counter-reaction to a rise in the minimum wage in early 2018. The inflation rate has been pushed up by import inflation due to the depreciation of the rouble that lasted into last autumn as well as the change in VAT rate (from 18% to 20%) introduced in January this year.

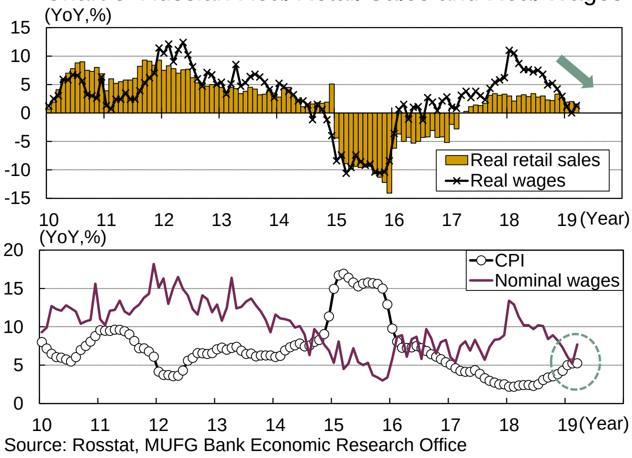
The employment environment is healthy, and unemployment was 4.7% in March (without seasonal adjustment), down 0.3 percentage points from the same month last year. Bearing this in mind, it is likely that once the temporary effects described above wear off, the economy will fundamentally stable, and is likely continue to see moderate growth. The infrastructure investment plan announced by the government in May 2018 is expected to provide support for economic expansion, and corporate hiring and investment intentions continue to improve

(Chart 9). In the currency markets, the rouble has been recovering since late last year, and is expected to remain stable looking forward, meaning that inflationary pressure is expected to ease gradually. Oil prices, which are the main determinant of the trend in the rouble market, are likely to stabilise around USD 60 (WTI price) per barrel[1]. This makes major upset in the rouble market unlikely.

1 Please see our oil price outlook for further details.

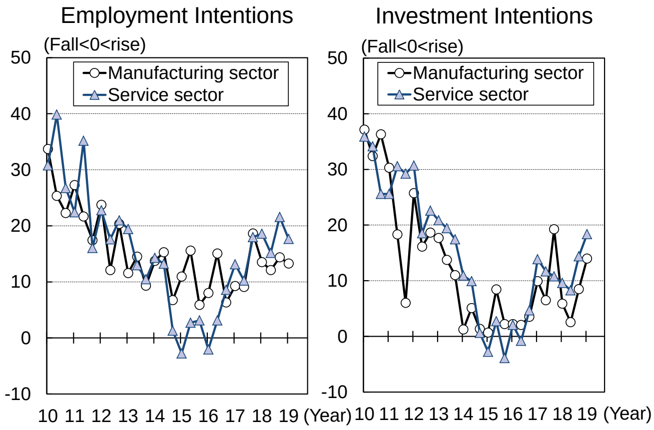
We forecast GDP growth in 2019 at 1.3% YoY, a moderate expansion that nevertheless represents a slowdown from 2018's growth rate of 2.3% YoY. In 2020, we forecast a slight pickup in growth to 1.5% YoY due to the fading of VAT effects on prices.

Chart 8：Russian Real Retail Sales and Real Wages



Source: Rosstat, MUFG Bank Economic Research Office

Chart 9: Russian Corporate Employment and Investment Intentions



Source: IHS Markit, MUFG Bank Economic Research Office

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