The Outlook for European Economies

Despite external risks, private consumption supports moderate economic growth

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1. Eurozone

1.1 Overview of the Eurozone Economy

In Q3 2019, Eurozone GDP growth was an anaemic 0.2% QoQ. In line with the previous quarter, domestic demand (especially private consumption) has supported growth otherwise dampened by manufacturing and weak external demand. This has resulted in both bright spots and areas of concern in the major euro area countries. France has, in line with previous quarters, outperformed the Eurozone average with growth of 0.3% QoQ, supported by domestic demand. Growth in Italy and Germany, on the other hand, has been almost flat at 0.1% QoQ. While Germany did narrowly avoid a technical recession (two consecutive quarters of negative growth), the pace of growth remains undeniably weak (Table 1).

Table 1: Real GDP Growth in Major European Countries

	2018 (YoY,%)				2019				2018 (actual) (YoY,%)	2019 (forecast)	2020 (forecast)
	Q1	Q2	Q3	Q4	Q1	Q2	Q3				
Eurozone	0.4	0.4	0.2	0.2	0.4	0.2	0.2		1.9	1.2	1.2
Germany	0.1	0.4	-0.1	0.2	0.5	-0.2	0.1		1.5	0.5	1.0
France	0.2	0.2	0.3	0.4	0.3	0.3	0.3		1.7	1.3	1.3
Italy	0.2	0.0	-0.1	-0.1	0.1	0.1	0.1		0.9	0.2	0.6
UK	0.1	0.5	0.6	0.3	0.6	-0.2	0.3		1.4	1.3	1.4

Source: Eurostat, MUFG Bank Economic Research Office

Taking a more long term view, Eurozone real GDP growth has seen anaemic growth of 0.2% QoQ for four out of five quarters since Q3 2018. This is against a backdrop of a slump in external demand following the slowdown in economies outside the region, as well as the downturn in the manufacturing cycle from its peak in late 2017 to early 2018. Firstly, exports have remained generally stable apart from a drop in Q2 2019 which came after the surge in UK import demand in the run up to the initial Brexit deadline (31 March). However, growth is slowing, and lacks the strength seen in late 2017. The key message from country-by-country data for industrial production is one of weakness in Germany, the region's key industrial powerhouse. The slump in the German automotive sector is particularly pronounced. Figures for German exports (which account for more than 75% of German automotive production) reveal that exports bound for the rest of Europe are the main cause of the slump, whereas exports to China (the largest global market) have seen a comparatively small decline. There

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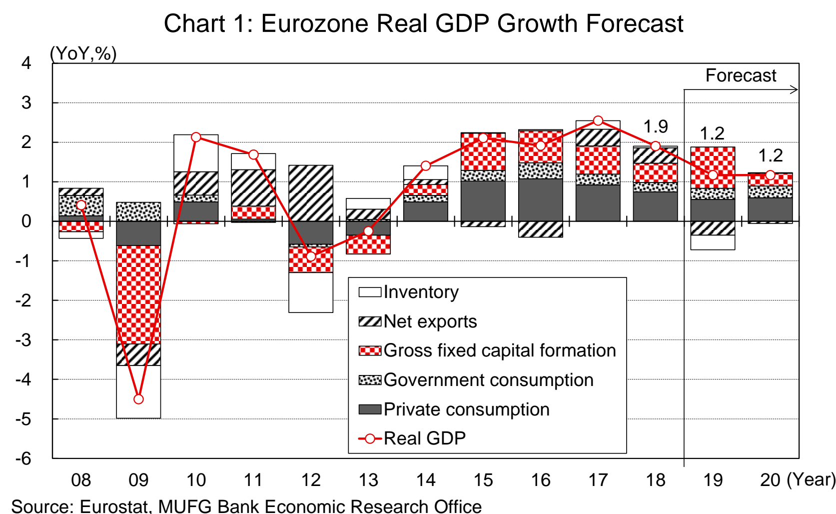
are various factors at play in the region, including the fading effect of post-European Debt Crisis pent-up demand, inventory adjustment, and tightening of EU emission standards. Germany has already banned diesel cars which meet the former Euro 5 emission standard in four cities, and other major European cities are also planning on introducing restrictions on diesel cars. New emission reduction targets are due to be introduced within the EU in 2020 as environmental regulations are tightened at an ever increasing rate. There is no denying that new environmental regulations have the potential to have a large impact on German manufacturers.

1.2 Key Points of the Outlook

The slump in manufacturing drags on and various issues in countries outside Europe continue to simmer. Despite this, the Eurozone economy as a whole is likely to continue to see moderate expansion supported by private consumption on the back of healthy employment and income conditions. Expansion in government spending is also expected to shore up growth in major economies. Real GDP growth is forecast to dip below potential (between 1.5%-1.9%) at 1.2% YoY in both 2019 and 2020 (Chart 1), but manufacturing is expected to recover in the latter half of 2020, leading to a gradual expansion in growth.

Chart 1: Eurozone Real GDP Growth Forecast



Source: Eurostat, MUFG Bank Economic Research Office

1.2.1 The Manufacturing Industry and Capital Expenditure

In addition to increased environmental regulations and sluggish external demand discussed above, the slump in the Eurozone manufacturing is linked to inventory adjustment. Inventory DIs have fallen below their European Debt Crisis low, due in part to Brexit-related stockpiling. The extent of this deterioration means that inventory adjustment is likely to affect the manufacturing sector for some time. However, inventory DIs tend to be cyclical, and the effects of inventory adjustment are expected to gradually ease as Brexit related uncertainty fades next year. By mid-2020 we expect that inventory adjustment will have a limited impact on growth (Chart 2 below).

The slump in the automotive sector is also showing green shoots of recovery: orders for exports (which account for 75% of German automotive production) seem to have reached a floor (Chart 3 below). Based on industry forecasts, it seems likely that the decline in European new car demand will stop next year, and we expect a rebound from the production slump that began in late 2018, meaning that automotive production is expected to bottom out and

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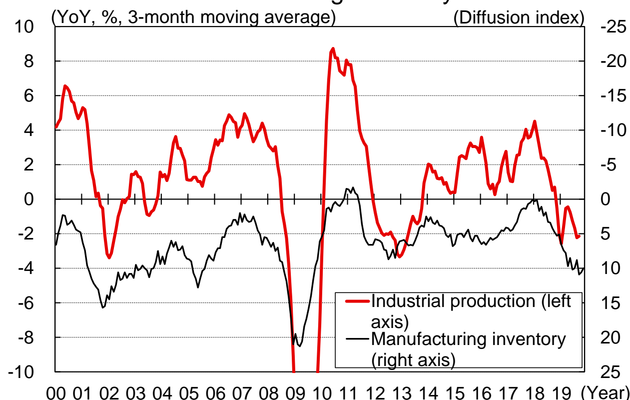
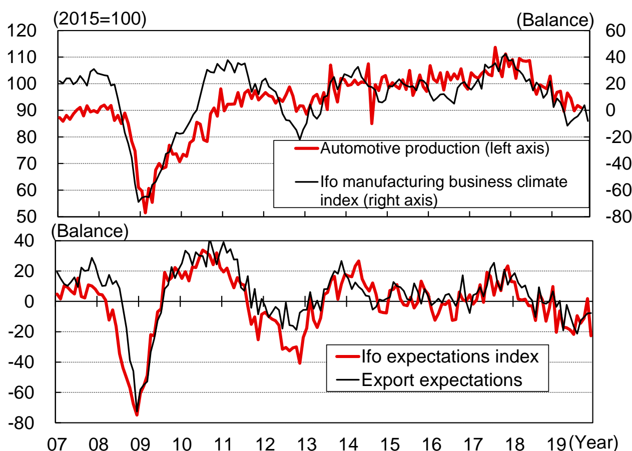
gradually improve. However, environmental regulations are likely to moderate the pace of the recovery. Turning to capital expenditure, capacity utilisation is on a downtrend amid prolonged weakness in production (Chart 4). Loan demand has fallen and looks likely to be flat when compared to the previous quarter. This links in to capital expenditure, where a slump seems inevitable. PMIs indicate that global manufacturing is showing signs of recovery, and we expect external demand to recover next year as automotive production bottoms out and the inventory adjustment phase comes to a close. Capacity constraints are also expected to gradually increase as production activity recovers. As discussed below, based on our main scenario of easing Brexit-related uncertainty, it is likely that capital expenditure will see a return to moderate expansion from 2020.

Chart 2: Eurozone Industrial Production and Manufacturing Inventory



Note: Axis for manufacturing inventory has been inverted
Source: Eurostat, European Commission, MUFG Bank Economic Research Office

Chart 3: German Automotive Sentiment and Production

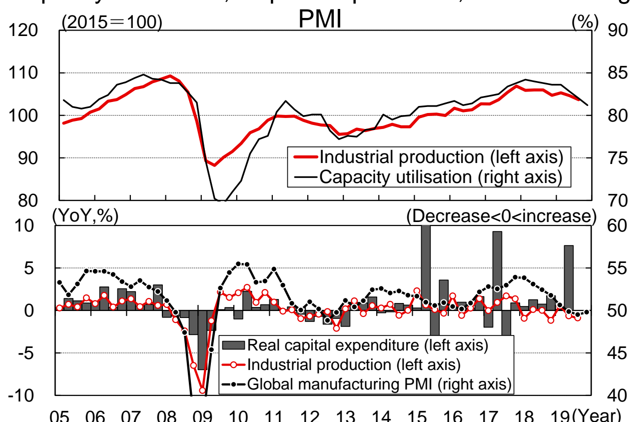


Source: Eurozone, Ifo, MUFG Bank Economic Research Office

1.2.2 Private Consumption and Capital Expenditure

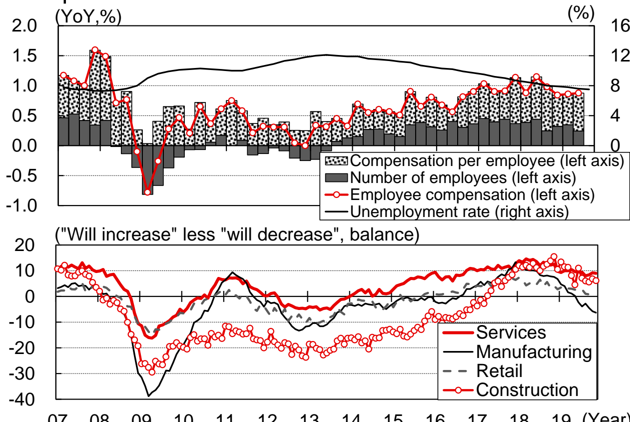
We now turn to the environment surrounding private consumption (the largest component of demand). Unemployment has fallen close to the pre-Global Financial Crisis (GFC) low, and corporate hiring forecasts remain healthy for the service sector, which makes up 75% of total employment in the region (Chart 5). Wage growth (compensation per employee) remains high, as does consumer sentiment, and there little evidence that the slowdown in the economy is affecting employment and income conditions.

Chart 4: Eurozone Industrial Production, Capacity Utilisation, Capital Expenditure, Manufacturing PMI



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

Chart 5: Eurozone Unemployment Rate, Employee Compensation & Businesses' 3-Month Labour Forecast



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

It follows therefore that healthy employment and income conditions will persist on the back of

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growth supported by expansion in private consumption.

1.2.2 Remaining Sources of Concern

Though green shoots are showing in certain areas of the Eurozone economy, risks still abound. Uncertainty persists over external political and policy factors which have contributed to the slump in external demand, such as US-China and US-EU trade tensions and Brexit stalemate in the UK. Depending on the outcome of the UK general election on 12 December, the Brexit process could once again descend into confusion. There are expectations in some quarters that a ceasefire could result from US-China trade negotiations, but there is plenty of room for re-escalation. If either of these situations deteriorate, the Eurozone's export environment, as well the economies of the countries involved, could be negatively affected.

The political situation in Europe also remains unstable. In Germany for example, the Social Democratic Party (SPD) coalition suffered major losses in the European Parliament Elections. The SPD has since seen numerous defeats in state elections, and has been unable to shake off speculation that it might break up. There is potential for political uncertainty to affect growth on a country-by-country basis.

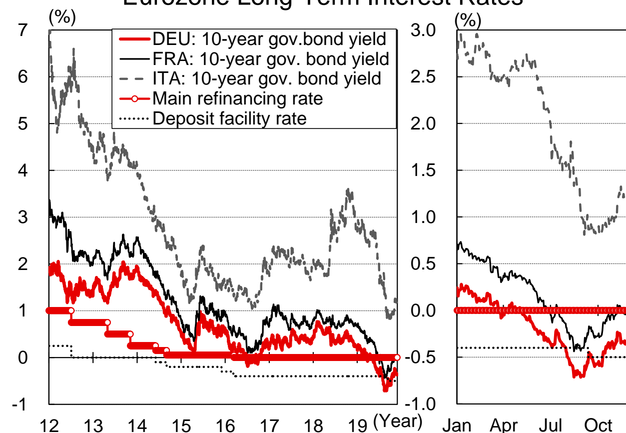
1.2.3 Monetary Policy Outlook

At the governing council meeting on 12 September, the European Central Bank (ECB) indicated that "The risks surrounding the euro area growth outlook remain tilted to the downside. These risks mainly pertain to the prolonged presence of uncertainties, related to geopolitical factors, the rising threat of protectionism and vulnerabilities in emerging markets." It also announced a large-scale monetary stimulus package: cutting interest rates further into negative territory (cutting the deposit facility rate from -0.4% to -0.5%), and reopening the asset purchase programme (APP) at a monthly pace of 20 billion euro. The introduction of this large-scale monetary stimulus package leaves little room for further easing, meaning that monetary policymakers' hands are tied when it comes to future measures. Since September, a number of senior figures at the ECB (including outgoing ECB president Mario Draghi) have spoken of the importance of fiscal policy, and expectations of further easing have receded in the financial markets (Chart 6 below).

Turning to the future of ECB policy under President Christine Lagarde, who took over the role in November, it seems likely that monetary policy will remain accomodative. That said, the ECB is likely to be cautious about any further rate cuts due to the limited room for further manoeuvre. The ECB has also introduced tiered deposit facility rates in order to mitigate the side effects of negative interest rates on European banks, but this doesn't mean that concerns over negative interest rates have gone away. As Draghi mentioned, there are 'mild signs' of overvaluation in the Eurozone financial and property markets: some countries have seen house prices soar, a risk factor which will be need to be borne in mind when contemplating any further easing policies. Moreover, it was clear from the press release from the 12 September meeting that several members of the Governing Council opposed aspects of the large-scale policy package, meaning that introducing further easing policies won't be easy. That said, consumer price inflation has dropped to 0.7% YoY, and inflation expectations remain low (Chart 7). The current slump in annual inflation can mostly be attributed to the rise in oil prices in late 2018, and core inflation (excluding energy, food, alcohol, and tobacco) has stabilised. Based on our growth forecast for the Eurozone, inflation is unlikely to hit the ECBs target of 2%

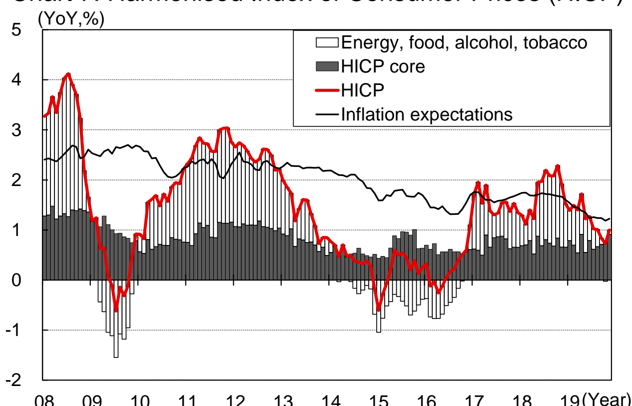
YoY. It is therefore hard to foresee interest rates being hiked in 2020, and we forecast that interest rates will be left unchanged.

Chart 6: ECB Policy Rates, Eurozone Long-Term Interest Rates



Source: Bloomberg, MUFG Bank Economic Research Office

Chart 7: Harmonised Index of Consumer Prices (HICP)



Note: 'Inflation expectations' is the monthly average of 5-year/5-year forward inflation expectations
Source: Bloomberg、Eurostat, MUFG Bank Economic Research Office

2. UK

After negative growth in Q2, the UK economy grew by +0.3% QoQ in Q3. Gross fixed capital took a hit from Brexit related uncertainty, falling by 0.2% QoQ, but employment and income conditions are still healthy and private consumption remained robust at 0.8% QoQ. On household incomes, nominal wages grew by a firm 3.6% YoY, and growth in real wages has stabilised around 2% YoY (Chart 9 below) due in part to the fading effect of sterling depreciation on inflation. Unemployment in Q3 was 3.8%, a historic low. This has shored up consumer sentiment, which in turn props up household spending. In the corporate sector, on the other hand, investor sentiment has worsened progressively since the Brexit referendum in 2016. Corporates have recently reported a rapid easing of capacity constraints, and reluctance to invest is becoming increasingly obvious (Chart 10 below). There are also signs that corporates are becoming more cautious on employment. Until now, given future uncertainty over the business environment and Brexit, corporates have addressed supply constraints by prioritising investment in labour over capital expenditure in order to avoid future issues with excess capacity. However, as the Brexit stalemate has dragged on and the slowdown in foreign economies has intensified, corporates have started to adjust their supply of labour too. We must bear in mind that the most recent survey of corporate sentiment was taken at a time when concerns of a 'no-deal' Brexit were particularly high. That said, as with a confirmed 'no-deal', if Brexit inertia continues into the long term, we can expect the drag on corporate investment and hiring appetites to increase progressively. This would heighten the risk of the downturn in the corporate sector spreading to households through the labour market.

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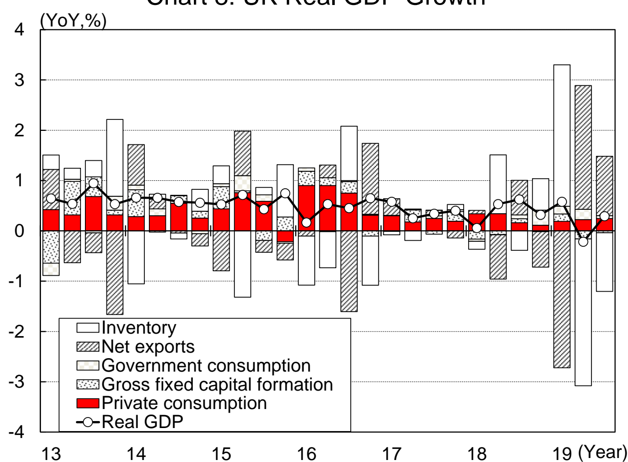
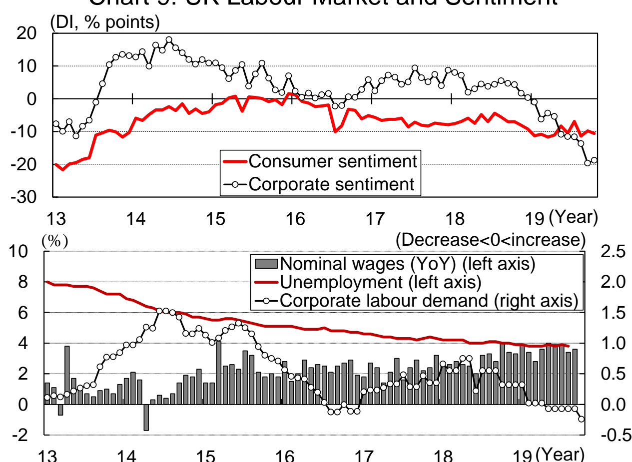


Source: ONS, MUFG Bank Economic Research Office



Source: ONS, BoE, MUFG Bank Economic Research Office

This means that the general election on 12 December hold a great deal of sway over the future of the UK economy. On 17 October, UK and EU negotiating teams reached an agreement on a revised withdrawal agreement, but parliament rejected the condensed timeline required for ratification of the withdrawal agreement bill, meaning that the Brexit deadline had to be extended yet again beyond 31 October 2019 to 31 January 2020. It was under these circumstances that two main parties voted to hold the third general election in four years, with the ruling Conservatives aiming to regain control of parliament, and Labour to stop Brexit under Boris Johnson.

The major parties' stance on Brexit (from most strongly pro to most strongly anti) is as follows: the Brexit party want a 'no-deal' Brexit, the Conservatives plan to 'get Brexit done' with a deal, the Labour party plans to hold a referendum offering a choice between 'soft Brexit', i.e. a close relationship with the EU and remaining in the EU, and the Liberal Democrats want to stop Brexit completely. This means that out of the two main parties, a Conservative majority would mean that the current withdrawal agreement will be approved in parliament by the end of January. A Labour victory on the other hand would mean yet another extension to allow the withdrawal agreement to be renegotiated with the EU, and to organise a second referendum (which generally takes around six months) (Chart 11).

Current opinion polls suggest a Conservative victory in the upcoming election. The Conservative party is currently polling between 35-40%, far ahead of the Labour party who are poling around 25-30%. On top of this, the Brexit party has announced that it won't contest seats which are currently held by the Conservative party, meaning that there the Conservative party are likely to win over pro-Brexit voters to gain a majority. The UK's 'first past the post' electoral system is designed to result in a single-party government. This means that the most likely scenario at the end of January is 'Brexit with a deal'.

Based on this scenario, Brexit related uncertainty is expected to ease, which is likely to result in a release of corporate capital expenditure that had hitherto been held back and stable employment. From a monetary policy point of view, the Bank of England (BoE) has so far maintained a policy of cautious rate rises. Central banks in the US and Eurozone have resumed easing policies, and policymakers are increasingly concerned over weakness in

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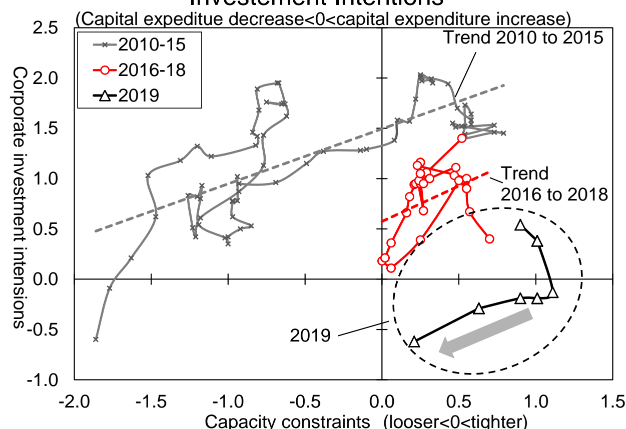
domestic and foreign economies. This makes it unlikely that the BoE will be tightening monetary policy in a hurry. Taking government spending pledges into account, we forecast that the UK economy will continue to see moderate growth. We expect real GDP to drop to 1.3% YoY in 2019, before accelerating slightly to 1.4% YoY in 2020.

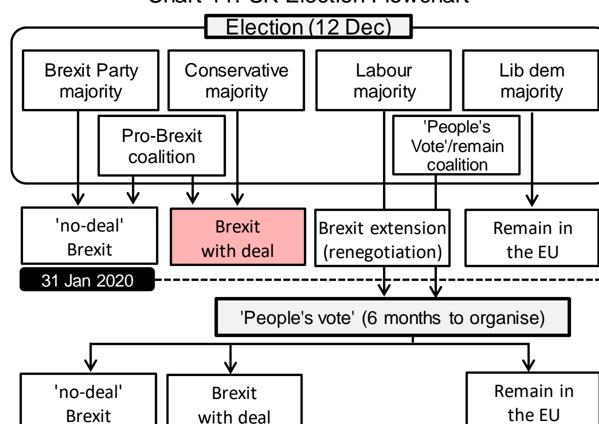
However, it is worth noting that recent election results have diverged from the outcomes of pre-election opinion polls, especially given highly polarised views over Brexit among the electorate. We also expect to see an increase in tactical voting (voting for a party other than one's first choice in order to get a particular result). This means that we should bear in mind the continued possibility of a 'no-deal' Brexit, as well as Brexit being cancelled.

Chart 10: UK Capacity Contraints and Corporate Investement Intentions



Source: BoE, MUFG Bank Economic Research Office

Chart 11: UK Election Flowchart



Source; MUFG Bank Economic Research Office

3.Russia

Russian real GDP growth was 1.7% YoY in Q3 2019, up from 0.9% YoY in the previous quarter (Chart 12). The Russian government has explained that this is mostly due a temporary contribution from inventory adjustment. Based on the fact that real retail sales growth has slowed, and PMIs are deteriorating, it seems unlikely that this is a sign that Russia has escaped economic stagnation.

Consumption had been affected by price rises due to rouble depreciation since 2018. There has been a break in rouble depreciation since the start of this year, and oil prices (which are vulnerable to changes in the rouble market) are currently robust (Chart 13), meaning that we expect lighter downward pressure from import prices on private consumption. The Russian central bank has cut interest rates four times in the since June, with the policy rate cut from 7.75% at the start of 2019 to 6.5% at the time of writing. This is expected to support the economy by increasing corporate and domestic funding demand.

On the other hand, US and European economic sanctions have increasingly weighed upon domestic and foreign investment to Russia. US sanctions on Russia were strengthened in August 2019, and it is difficult to foresee any easing in sanctions for now. The government's large scale 25.7 trillion rouble ($400 billion USD) national projects started in 2019 with the aim of joining the top 5 global economic powers. In the first half of this year, only around a third of

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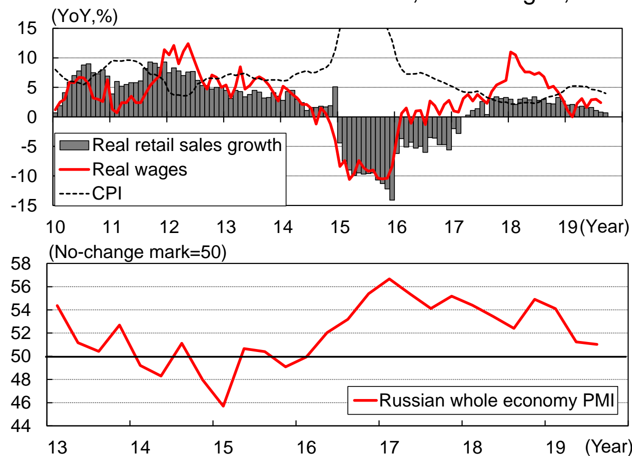
the federal funds allocated for National Projects initiatives were spent, and it remains to be seen whether the projects will provide sufficient stimulus to reinvigorate the economy.

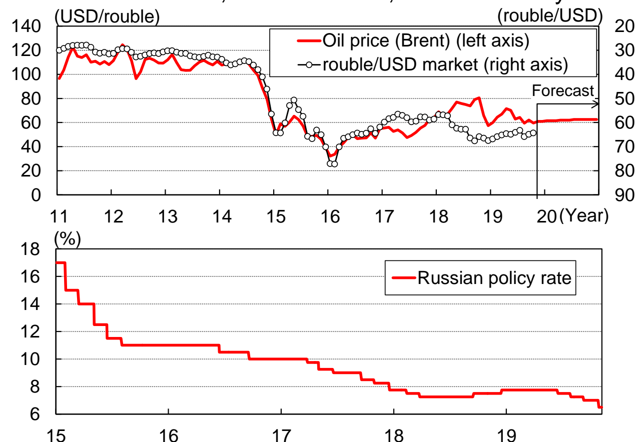
The Russian economy is expected to continue to grow, albeit at a moderate pace, with real GDP growth at 1.1% YoY in 2019 and 1.6% YoY in 2020.

Chart 12 Russian Real Retail Sales, Real Wages, PMI



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

Chart 13：Oil Price, rouble Market, Russian Policy Rate



Source: Bloomberg, Macrobond. MUFG Bank Economic Research Office

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