# Europe 2024 Outlook

**24 January 2024**

**HENRY COOK**
*Senior Europe Economist*

Economic Research Office

T: +44 (0)20 7577 1591
E: henry.cook@uk.mufg.jp

**MUFG BANK, LTD.**
A member of MUFG, a global financial group

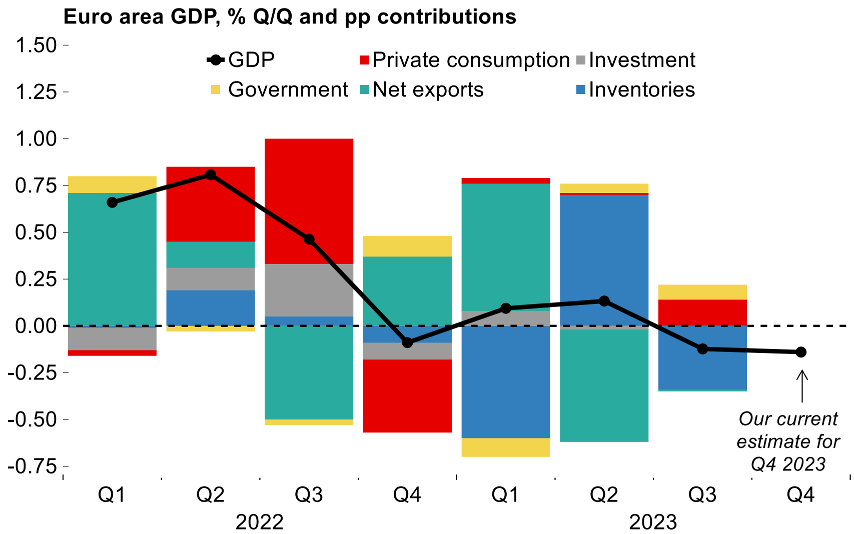
- It's likely to be confirmed that the euro area economy is in a mild recession, but the broader picture is one of stagnation rather than crisis. Survey evidence has stabilised somewhat and we expect growth conditions will gradually improve through the year. Despite a blip in the December HICP data we think that the disinflation process is set to continue, boosting households' real incomes, and monetary easing should also spur a pick-up in activity in H2. All in, we are *slightly* above consensus on euro area growth in 2024 and expect quarterly rates to improve towards potential by the end of the year.
- The UK economy is also likely to slip into recession, although it's a closer call than in the euro area. Stronger survey momentum suggests that the outlook is slightly brighter at the start of 2024. Pre-election tax cuts are set to combine with recovering household incomes to boost overall consumption growth. Monetary policy easing will likely provide further support. As with the euro area, we are a little above consensus on the UK this year and expect growth to pick up in H2.

## Euro Area

### The economy is teetering close to recession

The euro area economy probably slipped into a technical recession in H2 2023 (national accounts data will be released at the end of the month). It's likely to be a mild contraction with consecutive quarters of -0.1% Q/Q growth (Chart 1).

**Chart 1**: The euro area economy has looked increasingly stagnant




Source: Eurostat, MUFG Bank Economic Research Office

The underlying story is one of stagnation rather than crisis, but the near-term outlook remains challenging for the euro area economy. There was little momentum into 2024 against a backdrop of tight monetary policy and squeezed household finances. The business survey data released so far in January remains broadly consistent with zero or slightly negative growth again in Q1 this year.

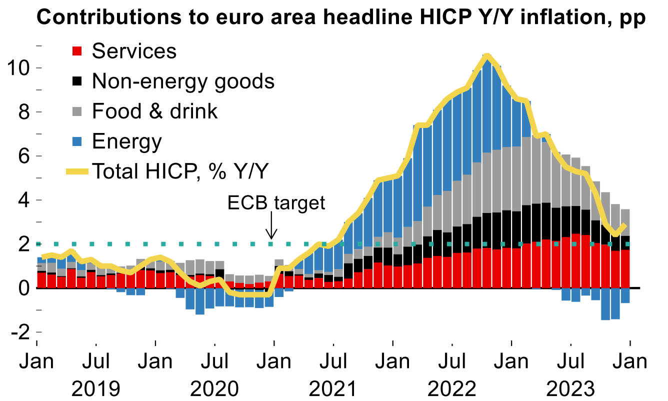
That said, there are some signs of stabilisation at least in some near-term indicators, and this hints at some cyclical improvement over coming months. We expect quarterly growth to pick up more noticeably in H2 this year, improving towards potential rates, driven by a recovery in households' real purchasing power and easier financial conditions.

**The disinflation process is set to continue this year**

The downward path for euro area inflation since the peak of 10.6% in October 2022 has been fairly smooth. Headline inflation fell steadily in 2023 as earlier energy price surges fell out of the annual calculation, but these downward base effects are no longer as forceful. There was a recent reminder that the road ahead could be bumpy when the headline rate increased 0.5pp to 2.9% in December (Chart 2). However, our view remains that inflation will continue on a generally downward slope this year. Core inflation edged lower to 3.9% and we think underlying price pressures will continue to ease against the backdrop of weak demand. Meanwhile, input price data suggests that food prices may start to contribute negatively to headline inflation rates, and gas prices have also fallen at the start of the year after Europe successfully navigated a cold snap.

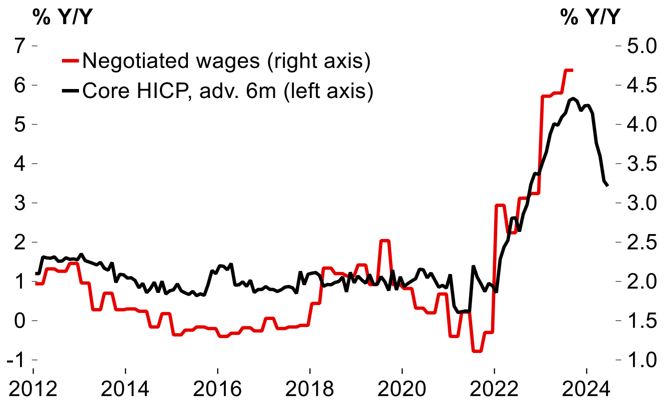
All told, we expect headline euro area inflation will fall back to the ECB's target by around mid-2024. This should boost both overall confidence and households' real purchasing power. Against that background, consumer spending is likely to contribute meaningfully to overall GDP growth by H2 this year.

**Chart 2**: Euro area inflation edged higher last month




Source: Eurostat, MUFG Bank Economic Research Office

**Chart 3**: Wage growth is a lagging indicator




Source: Eurostat, ECB, MUFG Bank Economic Research Office

**Rate cuts are coming – but perhaps not just yet**

Since pausing the hiking cycle in September 2023, officials have pushed back against rate cut speculation in an attempt to keep financial conditions tight. Last week, President Lagarde conceded in an interview that the chance of rate cuts in the summer is "likely". Acknowledging rate cuts are on the horizon is a significant shift in communication. In terms of timing, there have been a few efforts from officials to push back against market expectations for cuts in coming months. ECB chief economist Philip Lane highlighted that there will be "important data" on wage growth available to policymakers by the June meeting – the mention of a specific month feels like a pointed intervention.

Based on Lane's interview, it seems as though policymakers will lean on the fact that wage growth is still high as a reason to hold off declaring victory over inflation, and hence opening the door to easing, for a while yet.

There are credible reasons to be cautious: the euro area unemployment rate fell to an all-time low of 6.4% in November with the sluggish economy not yet translating into clear labour market loosening. The euro area wage tracker from Indeed, the jobs board, also edged higher in December to 3.9% Y/Y. This rate is not *that* inconsistent with the ECB's inflation target when accounting for productivity growth, and the general trend for pay growth remains downwards. We'd also highlight that wage growth is a lagging indicator when it comes to inflation (Chart 3). But the bottom line is that the ECB is wary of second-round effects from wage growth on inflation – or at least wants to seem that way to avoid loosening financial conditions – and does not yet seem ready for a more dovish shift in guidance. However, markets are pricing in over 125bp of cuts by year-end, which would provide a tailwind for spending and investment in H2.

### Growth to pick up in H2 2024

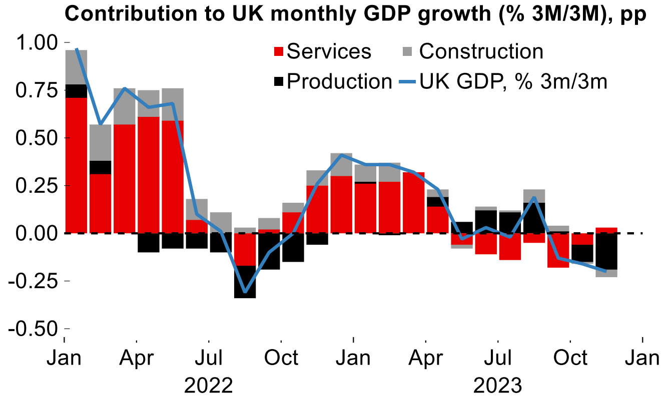
All in, we look for euro area GDP growth of 0.7% in 2024. It's important to note that this figure is affected by the likely contraction in H2 2023. The carryover effect – or overhang of growth dynamics in the previous year into the annual average figure – is set to be negative for the first time since 2013. Indeed, our forecast this year is actually *slightly* above consensus. On a quarterly basis, we expect euro area growth will pick up through 2024 and approach potential rates by the end of the year, with the main drivers being the improvement in households' real purchasing power and the likely easing of monetary policy.

## United Kingdom

### The economy stagnated last year, but prospects are brighter in 2024

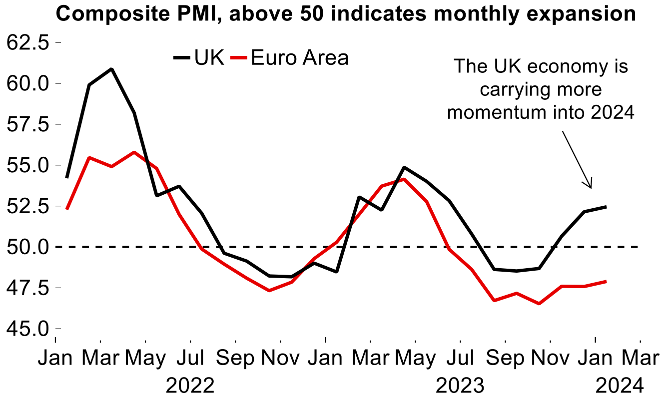
The UK economy probably also slipped into a technical recession at the end of last year. There was a mild contraction in Q3 (-0.1% Q/Q) after the initial estimate was revised lower. The latest data on monthly GDP up to November (Chart 4), combined with a sharp plunge in retail sales in December, points to another small contraction in Q4. However, the wider picture is one of a stagnant UK economy that has drifted sideways as monetary policy tightening and squeezed household finances have weighed on activity. Monthly output in November was 0.1% lower than at the start of 2023 – the overall trend was essentially flat last year.

**Chart 4**: UK growth tailed off in H2 2023




Source: ONS, MUFG Bank Economic Research Office

**Chart 5**: Better survey momentum into 2024




Source: S&P Global, MUFG Bank Economic Research Office

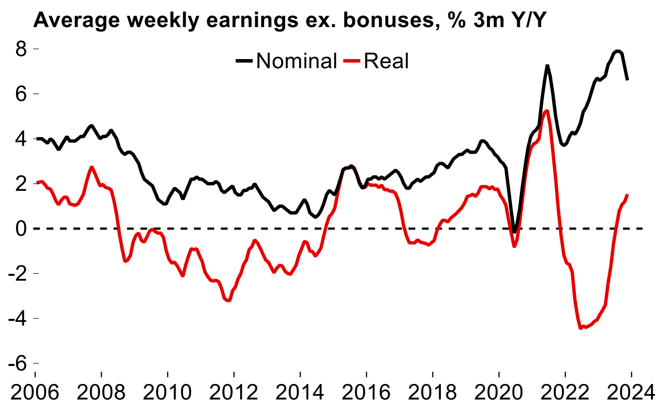
We expect better news (i.e. some *actual growth*) to come in 2024. There are now some signs in business surveys that the UK economy has carried slightly stronger momentum into the New Year. The UK composite PMI figure for January continued to improve into expansion territory (in contrast to the euro area equivalent – see Chart 5). The main driver of the UK expansion this year is likely to be the ongoing recovery in households' real purchasing power as inflation eases. We are slightly above consensus on UK growth this year at 0.6%.

**UK inflation may fall back to target by the summer**

UK headline inflation surprised to the upside in December, rising from 3.9% to 4.0%. This was largely driven by alcohol and tobacco prices after an increase in duty was announced in November. The core inflation rate held steady at 5.1%. The increase in the headline rate – the first in 10 months – is a reminder that the disinflation process may not be entirely plain sailing this year. Indeed, the headline rate is likely to increase again, slightly, in January after some unusual services price increases at the start of 2023 (as flagged by the BoE in the minutes of its December meeting).

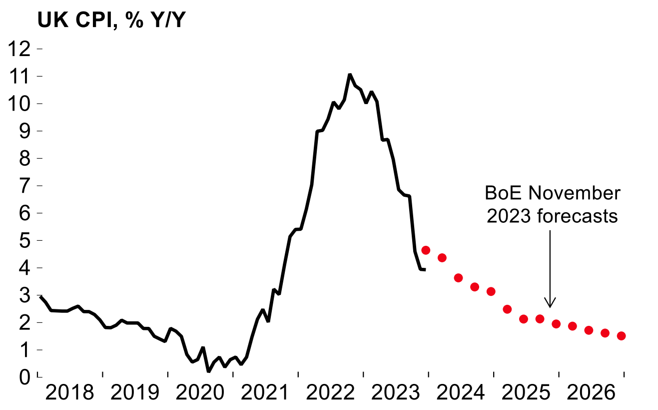
However, the general trend for headline inflation is likely to remain downwards through the year. Lower wholesale gas prices point to a significant (~15%) fall in household energy prices from April under the UK's energy price cap system. Input price data suggests that consumer food prices should also continue to ease through the year. This means that, after much talk about the UK's relative inflation problem (see here for our view last spring), it's very plausible that the headline rate of UK inflation will be below the BoE's target by the summer. This is plainly good news for households. Looking ahead, we are more optimistic about consumer spending – and growth more broadly – as real household incomes continue to recover (Chart 6).

**Chart 6**: Real pay growth is back in positive territory




Source: ONS, MUFG Bank Economic Research Office

**Chart 7**: BoE inflation projections set to be revised lower




Source: ONS, BoE, MUFG Bank Economic Research Office

**The BoE may be wary about declaring victory over inflation just yet**

In terms of policy implications, the Q4 average CPI rate of 4.2% easily undershoots the BoE November forecast (4.6%). A sizeable downgrade to the BoE's headline CPI projection in the February update is therefore likely (Chart 7). We think that BoE officials will be wary about declaring victory over inflation for a while yet, though. Underlying price growth may still prove a little sticky, even though it is moving in the right direction (our seasonally-adjusted core rate edged down to 2.3% on a 3m/3m annualised basis in the latest data release). Many mobile and broadband contracts will increase in April by the December rate of CPI plus the standard 3.9pp (i.e. 7.9%).

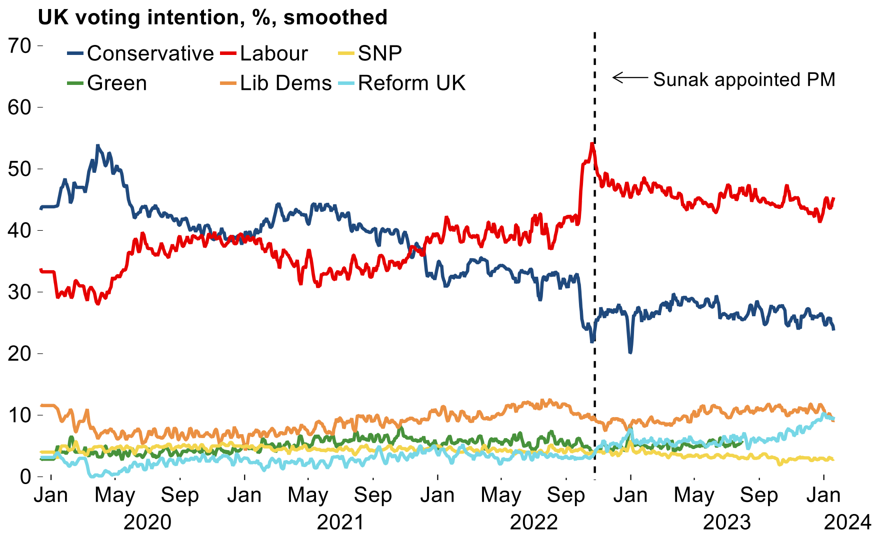
Meanwhile, official wage growth has fallen but remains uncomfortably high from a monetary policy perspective at 6.6% (3M Y/Y ex. bonuses) in November. The timelier PAYE estimate for December suggested that total pay growth may have edged up at the end of the year, and we know that the UK minimum wage will increase by 9.8% in April. We also expect some tax cuts in the Spring Budget on 6 March ahead of the upcoming UK election (see below), which would see fiscal and monetary policy pulling in opposite directions. Against that background, the BoE may be reluctant to pivot much before its May policy meeting. Markets are still currently pricing in around four rate cuts in 2024 which, if enacted, would provide a tailwind to growth. There are already signs of lower quoted mortgage rates in the UK, providing better news for households with fixed rate deals expiring this year.

**Tax cuts to come in what is set to be an election year**

The next UK general election must be held by January 2025 but will probably take place in autumn this year. The governing Conservative party have trailed behind opposition Labour in the polls since the end of 2021 (Chart 8). PM Sunak will hope that he can turn things around during the year with help from easing inflation pressures and better economic conditions.

Some personal tax cuts were announced in late 2023 and we expect more to come at the next Budget (6 March). The downward shift in interest rate expectations and slightly faster-than-expected disinflation process may have given the chancellor some room to do so without upsetting gilt markets. It's possible that there could be further pre-election giveaways announced in October/November as well. The longer-term context is important: the UK tax-to-GDP ratio has steadily increased since the pandemic as income tax thresholds have been frozen rather than uprated with inflation. Nonetheless, a shift in fiscal policy poses a clear upside risk to our growth forecasts.

**Chart 8**: Labour's polling lead has held steady for over a year




Source: EuropeElects, MUFG Bank Economic Research Office

In terms of the election result, there's been little sign of any shift in voter preferences towards the Conservatives, and local and special election results last year were broadly consistent with the national polling trends. The evidence at this stage points to a Labour government after the next election. In fact, the wide gulf in the polls suggests less uncertainty around the upcoming UK vote than has been the case in recent elections, as things stand.

Policy risk around the election also seems relatively low. Keir Starmer, the Labour leader, and Rachel Reeves, his shadow chancellor, have repeatedly emphasised that Labour would follow a pro-business approach and err on the side of caution when it comes to public finances. ‘Market unfriendly’ policies (of the sort proposed by some previous Labour leaders or actually implemented in the Liz Truss government’s ill-fated ‘mini Budget’) seem unlikely.

Policies aside, the UK economy would probably benefit from the period of relative calm and stability that a new government with a sizeable majority would bring after the Brexit years and five prime ministers in eight years. This could have some positive implications for business investment and confidence more broadly in the UK.

## GDP & CPI Forecasts

### MUFG Bank Economic Research Office Forecasts

| | Real GDP (% Y/Y) | | | Consumer Prices (% Y/Y) | | |
|---|---|---|---|---|---|---|
| | 2022 | 2023F | 2024F | 2022 | 2023 | 2024F |
| **Euro area** | 3.4 | 0.5 | 0.7 | 8.4 | 5.5 | 2.3 |
| Germany | 1.8 | -0.3 | 0.6 | 8.6 | 6.1 | 2.4 |
| France | 2.5 | 0.7 | 0.8 | 5.9 | 5.7 | 2.2 |
| Italy | 3.7 | 0.8 | 0.8 | 8.7 | 6.0 | 2.1 |
| **UK** | 4.3 | 0.5 | 0.6 | 9.1 | 7.4 | 3.0 |

Forecasts released 1 December 2023. Source: National statistics offices, MUFG Bank Economic Research Office