Europe Outlook - H2 2024

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- The euro area economy is in reasonable shape but the recovery is likely to be a steady one. Consumer conditions continue to improve but it's hard to make a case for a protracted period of buoyant growth given persistent policy uncertainty, longer-term structural impediments for the industrial sector and the likelihood of fiscal consolidation ahead. While the ECB has started the ball rolling on rate cuts, the overall monetary policy setting is also likely to remain restrictive for some time. Against that backdrop we see growth at 1.4% next year, close to potential.

- After an extended period of stagnation, the UK economy has clearly started the year on a firm footing and is set for another healthy Q2 growth figure. We expect a slight slowdown in H2 but remain upbeat on the broader UK outlook. As well as improving real income conditions, the return to political stability following this month's decisive election result is positive after the turbulence of the Brexit years. On monetary policy, BoE officials remain notably divided over the persistence of inflationary pressures which has increased doubts around the timing of the first rate cut.

Euro Area

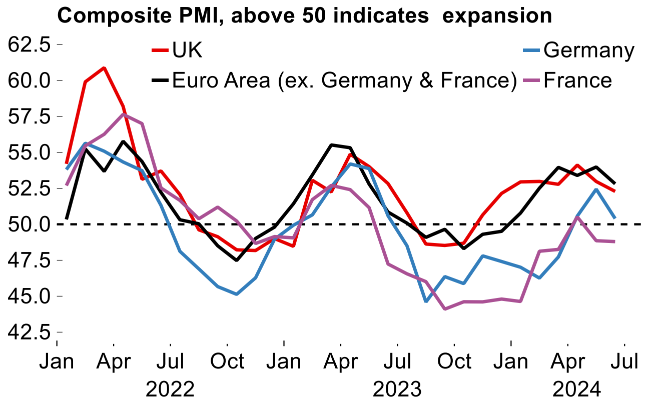
A steady economic recovery

The euro area economy started this year in reasonable shape with 0.3% Q/Q growth in Q1 but momentum seems to have faded somewhat in recent months after bad news on industrial production (especially in Germany, which continues to act as a brake on overall euro area activity) and soft-ish retail sales figures. Sentiment has weakened slightly too, with the euro area composite PMI slipping to 50.9 in June (although that may have been affected by uncertainty in France and could recover in July after the more extreme election scenarios did not materialise). We are now tracking Q2 euro area growth at 0.2% Q/Q. The first estimate will be released next week.

We would see any slight slowdown as a reminder that it's likely to be a steady recovery rather than a sharp one. Lower borrowing costs and the ongoing recovery of real incomes after the 2021-23 inflation shock are set to result in household expenditure becoming an increasingly reliable driver of growth. Public investment related to the EU's recovery fund is also supporting activity to an extent, especially in peripheral euro area members which continue to outperform the core.

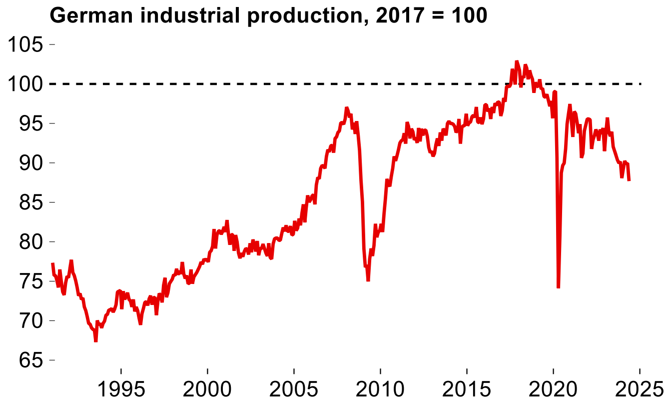
Various factors are likely to limit the pace of the expansion. The ECB has started the ball rolling on rate cuts now but it's likely to be a gradual easing cycle, with the overall policy setting remaining restrictive for some time (see below). On the fiscal side, we also expect to see more consolidation efforts from governments after a period of loose spending during the pandemic and then the energy crisis. Meanwhile, uncertainty related to the conflict in Ukraine and US trade policy continues to weigh on sentiment. This adds to the structural headwinds facing industry which include comparatively higher energy costs, shortages of skilled workers and increased competition for auto exports from China. Against that background, we think it's unlikely that growth will sustainably exceed potential. We see average annual growth at 0.7% this year and 1.4% in 2025, in what would be a middling recovery.

Chart 1: Fading growth momentum in Q2?



Source: IHS Markit, MUFG Economic Research Office

Chart 2: Still no recovery for German industry

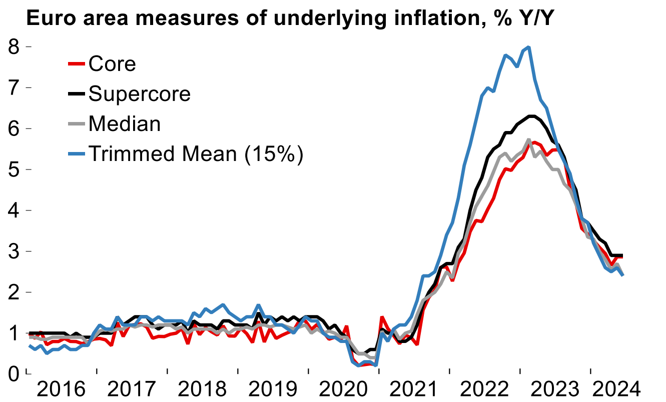


Source: Statistisches Bundesamt, MUFG Economic Research Office

The ECB is determined to retain flexibility over the pace of rate cuts

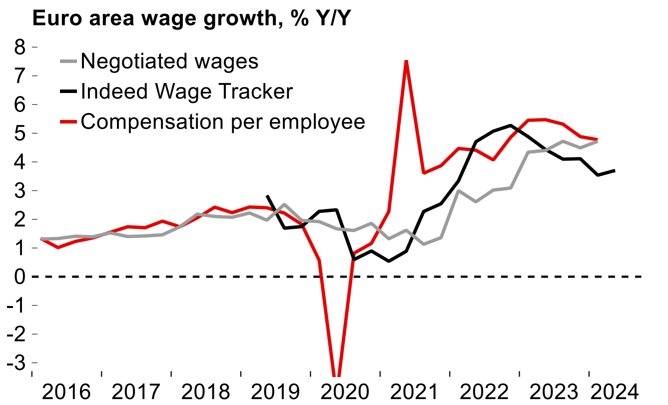
That means that the ECB finds itself in the unprecedented situation of embarking on an easing cycle against a more-or-less benign macro backdrop (rather than an acute crisis). Policymakers had clearly signposted the June meeting for the initial cut for several months in advance but the near-term data flow was not exactly supportive at the finish – the central bank found itself in the awkward position of cutting rates while simultaneously raising its inflation forecasts following sticky wage growth numbers. Following on from that, it's clear that the ECB now has no intention of setting out a specific easing schedule. The statement from last week's low-key policy meeting noted that the Governing Council "is not pre-committing to a particular rate path" with unchanged guidance stating that policymakers will "continue to follow a data-dependent and meeting-by-meeting approach".

Chart 3: Underlying inflation is now below 3%



Source: ECB, Eurostat, MUFG Economic Research Office

Chart 4: Nominal wage growth remains elevated



Source: ECB, Eurostat, Indeed, MUFG Economic Research Office

The ECB's overall tone on inflation remains cautiously optimistic. The central bank continues to monitor three aspects especially closely: wages, profits and productivity. Reasons for some encouragement were noted on all of these. Lagarde stressed that high wage growth may reflect the catch-up process with inflation reflecting some compensation for workers after the loss of purchasing power in recent years and that unit profits have fallen amid signs of absorption of these additional labour costs. It was also suggested that productivity growth could pick up as “hoarded employees” are asked to respond to higher demand.

There will be a range of relevant data points before the next policy meeting in September (including two inflation prints and key wage growth numbers). Provided that the bulk of this moves in the right direction we believe that the ECB will be comfortable with cutting rates again, but there is still a degree of uncertainty. Nominal pay growth is still high from a monetary policy perspective and the pre-commitment to a cut in June meant that we didn’t learn much about the ECB’s reaction function. Indeed, the ECB’s framing of a summer’s worth of data at the next meeting, as well as any action from the nominally flexible standpoint, may well reveal a lot about its intentions going forward. To our minds, gradual easing at around a quarterly pace looks a reasonable assumption, which would mean policy remaining restrictive, to a lessening extent, through 2025.

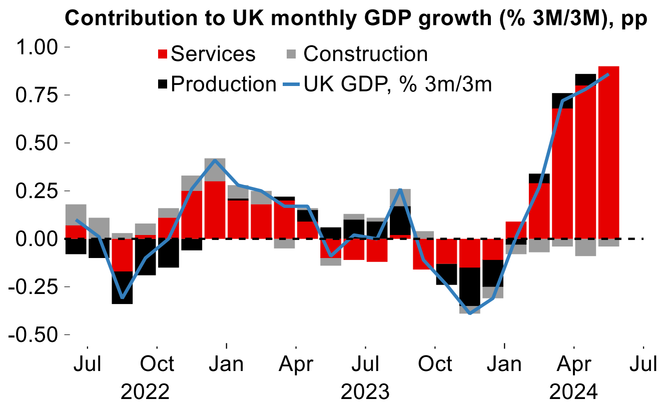
United Kingdom

The economy has started the year brightly and now stands to benefit from increased political stability

The UK economy started the year more strongly than the euro area with growth of 0.7% Q/Q in Q1. The monthly estimate of GDP points to another strong showing in Q2: the economy has grown by 1.5% between May and December last year. This comes despite some signs from higher-frequency and forward-looking indicators that momentum may have moderated somewhat in recent months. We suspect that the headline growth figures have likely been boosted from the reduction in public sector industrial action and we look for lower Q/Q growth in H2 this year. However, underlying conditions are set to remain supportive. Real pay continues to recover with the latest data showing nominal pay growth around 5% and headline inflation now at 2%. As with the euro area, consumer spending is likely to become a more consistent driver of growth.

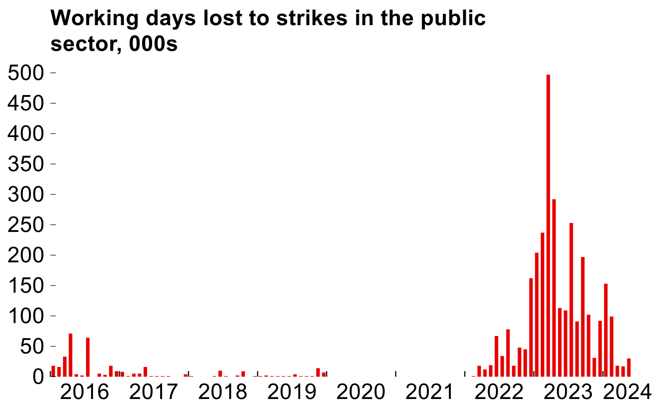
We also see the UK benefitting from the return to political stability following Labour’s decisive election victory this month (see here). A stable government with a large majority is certainly welcome after the turbulence of the Brexit years, and we believe it will herald better business investment figures. Indeed, the UK may increasingly be seen as a source of relative stability in Europe (after almost a decade of the opposite being true).

Chart 5: The UK economy has picked up pace at the start of the year



Source: ONS, MUFG Economic Research Office

Chart 6: Distortions from strike action are fading



Source: ONS, MUFG Economic Research Office

In terms of policy, the new UK government is constrained by limited leeway to the primary fiscal rule that debt-to-GDP should be falling over the medium-term. But the proposed reform to construction restrictions would be growth-friendly, if actually implemented, as would any measures to ease EU/UK trade friction.

We've been relatively optimistic on the UK outlook but may revise up our current above-consensus forecast (0.9% in 2024) in our next update given the likelihood of strong back-to-back quarters of growth at the start of the year. These are likely to mark an inflection point after an extended period of stagnation for the UK economy.

That said, as with the euro area, it's still hard to make a case for UK growth to remain *sustainably* high in the absence of supportive external conditions (e.g. a synchronised global upswing). The boost to consumer spending as real incomes recover is likely to be tempered by an increase in saving: the household saving ratio risen steadily over recent quarters to 11.3% in Q1 (2019 average: 5.5%). Meanwhile, a degree of fiscal tightening is on the horizon – we expect tax rises in the autumn – and monetary policy is set to remain restrictive.

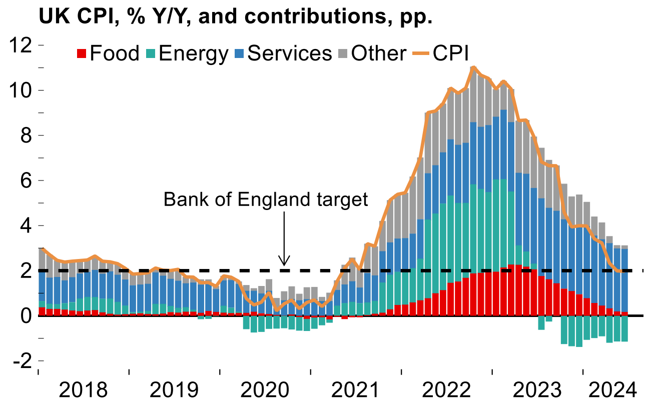
The BoE remains divided about the persistence of inflationary pressures

We thought that BoE officials might use speeches after the election blackout period to further tee up an initial move after opening the door to easing at the last meeting in June. It's mostly been a case of the opposite. Particularly notable was an intervention from Huw Pill, the BoE's chief economist. In reference to inflation now being back at 2% he said that "it is not enough to meet the target in a transitory or fleeting way" and highlighted that there are "upside risks" to his assessment of inflation persistence. In the room Pill also talked about the economy's "speed limit" several times, suggesting that there may be some concern around inflationary pressures generated by the UK economy's upshift since the start of the year.

In terms of data, there haven't been any significant shocks since the last meeting, but on balance there's been more ammunition for the hawks. While headline inflation remained at 2% in June, bang on target, the core and services components did not budge either (remaining at 3.5% and 5.7% respectively). Pay growth edged down a little, but progress is slow and, at 5%+, it is still far from being consistent with the inflation target. The headline inflation rate remains on course to rise again later in the year as declines in energy costs slip out of the calculation.

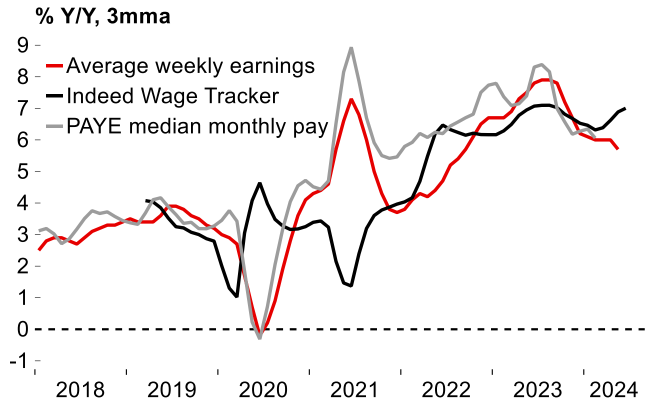
So an August rate cut now looks finely balanced. The BoE is still edging closer to easing policy – Pill acknowledged that it's a question of "when rather than if" – but the MPC is clearly very divided on the persistence of underlying inflationary pressures and this points to a gradual and cautious start to the rate cut cycle.

Chart 7: Inflation at target but services prices are sticky



Source: ONS, MUFG Economic Research Office

Chart 8: Nominal pay growth remains elevated in the UK



Source: ONS, Indeed, MUFG Economic Research Office

GDP & CPI Forecasts

MUFG Bank Economic Research Office Forecasts

	Real GDP (% Y/Y)			Consumer Prices (% Y/Y)		
	2023	2024F	2025F	2023	2024F	2025F
Euro area	0.4	0.7	1.4	5.5	2.3	2.0
Germany	-0.3	0.2	1.1	6.1	2.4	2.1
France	0.9	0.8	1.3	5.7	2.5	2.0
Italy	0.9	0.8	1.0	6.0	1.6	1.9
UK	0.1	0.9	1.6	7.3	2.6	2.3

Forecasts released 31 May 2024. Source: National statistics offices, MUFG Bank Economic Research Office

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