Europe Monthly

Chris Scicluna
+44 20 7597 8326
Chris.Scicluna@uk.daiwacm.com

Overview

After a strong start to 2016, euro area GDP growth moderated in the second quarter close to the average rate of the recovery so far. All the signs are that steady growth is set to continue with economic confidence stable and financial conditions easing in response to ECB policy. But while inflation is back above zero and set to rise gradually over coming quarters, it will likely remain some way below target for the foreseeable future. To avoid an unhelpful tightening of financial conditions over coming quarters, we expect the ECB to extend its QE programme, perhaps in September.

In the UK, Brexit-related uncertainty has seriously harmed confidence among consumers and businesses, and firms are putting investment and recruitment plans on ice. So, although inflation is set to rise above target next year, the BoE cut Bank Rate to a record low, re-launched QE and announced a new bank funding scheme. Fiscal policy is also likely to become less restrictive. But the UK economy looks to have entered recession from Q3 and further BoE easing is likely.

Key issues

After June's referendum, new UK Prime Minister Theresa May insists that ***'Brexit means Brexit'.*** But, in reality, Brexit could mean countless different things, and there remains a huge vacuum where a meaningful policy should be. Not least due to the multi-dimensional relationship between the UK and EU that must now be redesigned, the complexity of the existing rules governing European and global trade, and the lack of pre-referendum planning by the UK government, it is going to be a long time before investors can have a clear idea about what Brexit will actually mean in practice.

In particular, the UK government is unlikely until next year to invoke Article 50 of the EU Treaty, starting the clock on a negotiation lasting up to two years (extendable by unanimity) to determine the UK's legal separation from the EU. That process will only cover mundane issues such as budget payments, '*Eurocrat'* pension rights, etc. More substantive will be separate, challenging, talks on future arrangements for trade in goods and services and the movement of people between the UK and EU, which will not start before Article 50 has been invoked and possibly not until the basic negotiations have been concluded. Continued membership of the EU's Customs Union might not be beyond the realm of possibilities although a new free trade agreement (FTA) between the UK and EU, broader in scope than the deal between Canada and the EU that recently emerged from talks launched over seven years ago, is more likely. But that would take several years to negotiate and ratify, requiring an interim deal to govern the period after the UK has left the EU until the coming into effect of the FTA. Other complexities include those related to achieving UK membership of the WTO.

The massive uncertainty related to Brexit is now weighing heavily on the UK economic outlook with surveys showing a sharp deterioration in business and consumer confidence. Firms' investment and recruitment plans are being put on hold, and construction activity has slowed. In response, on 4 August, **the BoE** eased monetary policy with a package of measures. Having been unchanged since early 2009, Bank Rate was cut by 25bps to a record low of 0.25%. The BoE also committed to increase its Gilt holdings over the coming six months by £60bn to £435bn, to take its share of the market from 25% to about 29%, and launched a new programme of purchases of up to £10bn of corporate bonds over the coming eighteen months. And it announced a new Term Funding Scheme (TFS) to ensure that the cut in Bank Rate feeds through into lower funding costs for banks. Carney also made clear that, if the economy evolves as the BoE expects, further easing will be likely. Action is most likely to come in November, when Bank Rate will likely be cut to 0.10%, which would then represent the lower bound. A further increase in asset purchases and/or revision of the TFS to make it more generous might also seem likely to be forthcoming.

In the **euro area**, the economic impact of Brexit so far looks minimal. ECB policy action has helped prevent a significant tightening of **financial conditions**, locking in progress of recent quarters during which credit standards eased steadily while average interest rates on new loans to households and businesses fell to record lows. Such has been the pace of recent declines in interest rates in Italy and Spain, according to ECB data, it is now cheaper for small businesses in those countries to borrow than their peers in Germany. But while the results of the latest EBA stress tests suggested that lenders were more robust than two years ago, that does not mean that all is well in the euro area's banking sector. Among other things, persistent concerns about profitability across the region, as well as the convoluted plan to resolve Monte dei Paschi di Siena's undercapitalisation and NPLs without the use of public funds, means that investors remain uneasy about the sector.

Meanwhile, **sentiment surveys** signal that firms and households are broadly unperturbed by the deterioration in economic conditions in the UK events and suggest that euro area economic growth at the start of Q3 was broadly in line with the 0.3%Q/Q rate of Q2. So, when the **Governing Council** meets again in September, the ECB's economic forecasts might be little changed from the set produced in June suggesting that policymakers might well be in no hurry to ease policy again. But the ECB will be aware that risks to the outlook remain skewed to the downside, and there is a good chance that inflation will remain well below its 2%Y/Y target over coming years. So, to avoid an unhelpful tightening of financial conditions over coming quarters, we expect the ECB in due course to extend its QE programme by a further six months to September 2017. And as government, supranational and agency bonds amounting to more than €1.5trn, including all Bunds with a maturity of seven years or fewer, are currently ineligible for the ECB to purchase because their yields are below the deposit rate of -0.40%, the ECB will also need to review the rules of its QE policy to ensure that it can continue to meet its purchase target. Options include abolition of the issue limit applied to any particular bond and/or the yield floor on bond purchases; and the addition of other assets to the list of securities that the ECB is willing to buy.

Euro area

As expected, euro area GDP growth moderated in the second quarter to 0.3%Q/Q, half the rate of Q1 but close to the average rate of the recovery so far. While this is a preliminary reading subject to revision, and no expenditure breakdown is available, judging from the monthly data, consumer spending – which has been the principal source of the recovery over the past couple of years – looks to have slowed in the second quarter with growth in retail sales down to just 0.1%Q/Q and new car registrations falling slightly. In contrast, net trade looks to have provided a positive contribution to GDP growth for the first quarter in a year principally due to significant weakness in imports. So far, many member states have yet to report their headline Q2 growth numbers. However, of those countries that have published figures, Spain's growth of 0.7%Q/Q means that it is highly likely to have remained the strongest growing of the larger member states, while Belgian growth accelerated to a respectable 0.5%Q/Q. In contrast, following a strong first quarter with growth of 0.7%Q/Q, French GDP was disappointingly flat in Q2. Of those member states yet to provide data, we expect German growth to have slowed in line with the euro area figure to 0.3%Q/Q and Italian growth slowed to 0.1%Q/Q.

On balance, the July economic surveys beat expectations suggesting that growth momentum was steady at the start of the third quarter. Consistent with other useful gauges of activity such as the PMIs and certain national surveys, the Commission survey – which often provides the most reliable guide to growth – saw the overall euro area economic sentiment indicator (ESI) post a modest increase to above the average of the first half of the year and close to the top of the range of recent years. While consumer confidence posted a slight deterioration, it remained above the average of the first half of the year. And contrary to expectations of a decline, business confidence rose to its highest level of the year to-date. With financial conditions remaining highly accommodative, we now expect euro area GDP growth to remain stable at 0.3%Q/Q in Q3, with Germany and France a touch firmer than in Q2 but Spain a touch softer. Thereafter, as it becomes more obvious that the UK economy, which accounts for about 13.5% of euro area goods exports, has deteriorated markedly, the impact of uncertainty on investment and weaker external demand will likely contribute to a modest slowdown in euro area GDP to 0.2%Q/Q in Q4.

Inflation in the euro area is back in positive territory and continuing to pick up gradually. Headline CPI rose in July to 0.2%Y/Y, the highest level in six months. While the decline in energy prices continued to be the most significant drag on inflation (down 0.2ppt to -6.6%Y/Y), non-energy industrial goods inflation remained subdued at 0.4%Y/Y, while services inflation edged only slightly higher by 0.1ppt to 1.2%Y/Y. So, the improvement principally reflected a ½ppt increase in food price inflation to 1.4%Y/Y, its firmest rate in eight months. As such, core CPI remained unchanged at 0.9%Y/Y, consistent with a continued absence of meaningful price pressure. As the impact of past declines in energy prices eventually wears off, we expect headline CPI to rise close to 1%Y/Y by year-end. But given the subdued growth outlook, we also expect inflation to remain below 1.5%Y/Y throughout 2017 and into 2018, justifying the extension of the ECB's asset purchase programme.

UK

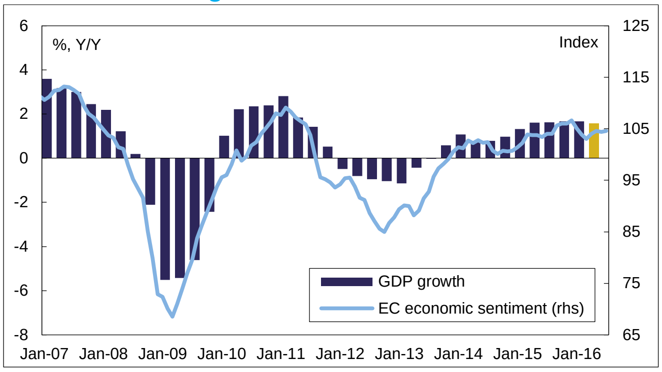
The July surveys have made clear that Brexit-related uncertainty is weighing heavily on the UK economy. With the PMIs typically providing one of the most reliable guides to economic growth, their latest readings were of particular concern, suggesting that GDP might now be contracting at the fastest pace since the global financial crisis. Most notably, the headline composite PMI posted its steepest monthly drop on the series of 5pts to 47.5, the lowest level since April 2009. And most of the detail provided troubling reading too. Services firms, which dominate the UK economy, look to have been hit harder than manufacturers, but both sectors appears to be contracting: the services activity PMI fell almost 5pts to 47.4, the lowest since March 2009, while the manufacturing PMI fell more than 4pts to 48.2, the lowest since 2012 despite the new export orders index remaining above 50 on the back of weaker sterling. Indeed, with the overall manufacturing new orders index falling 8pts, the most since 1998, the composite new orders index also fell close to 7pts, the biggest monthly drop on the series, to foreshadow troubled times ahead.

The PMIs, and other surveys too, also suggest that firms are now cutting back on employment with investment plans similarly being pared back. Indeed, the BoE's agents report suggested that about a third of companies anticipate a negative impact on their capital spending, with planned inward foreign direct investment being postponed and a number of companies considering alternative European locations for aspects of their business.

Given the likely marked drop in investment and slowing in consumer spending, we forecast the UK economy to contract by 0.4%Q/Q in Q316, and to shrink again in Q416 and Q117 too. And while we expect growth to return thereafter (for a while at least), it can be expected to be lacklustre at best, weighed down by continued political uncertainty and downward pressure on real household incomes. That is a more downbeat view than the BoE's forecast presented on 4 August, which sees GDP continuing to rise in the second half of this year, albeit at a very slow rate, before picking up gradually to reach 2%Y/Y by the end of 2018. Nevertheless, particularly in light of the recent dire surveys, the BoE recognises the significant downside risks to that outlook. And even if the economy follows the relatively sanguine path envisaged by the BoE over the near term, the majority of MPC members still expect to ease policy further. With Carney having also effectively ruled out a move to negative rates, we expect Bank Rate eventually to be cut to 0.10%, which would be the effective floor, and the BoE's Gilt purchase programme to be extended beyond the current planned period of six months.

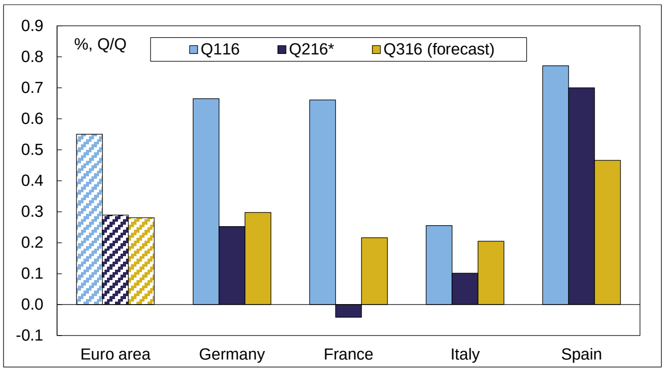
Despite the anticipated weaker path for GDP, due to the depreciation in sterling, we expect UK inflation to rise back above the BoE's target from the second quarter of next year and to more than 2½% by end-2017. The BoE thinks that the increase will be a little more gradual, to about 2%Y/Y by the end of next year. But it expects inflation to rise further thereafter and subsequently stay above the 2%Y/Y target into 2019. Nevertheless, that reflects the conscious decision of the MPC to repeat the approach taken during the global financial crisis, whereby its overriding priority is to support GDP growth and limit the rise in unemployment rather than achieve its inflation target over a 'normal' timeframe.

Euro area: GDP growth* & economic sentiment



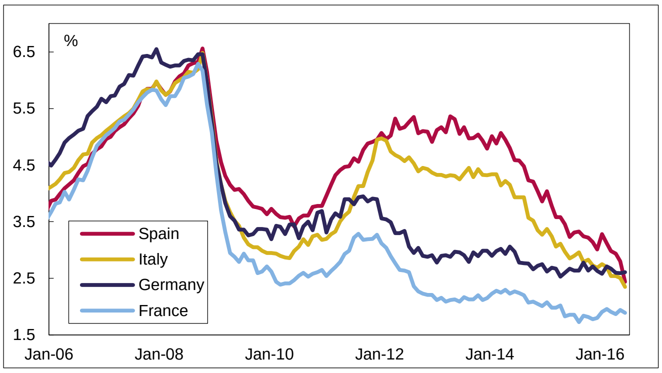
**Daiwa forecast for Q316.*
Source: Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area and member states: GDP forecast



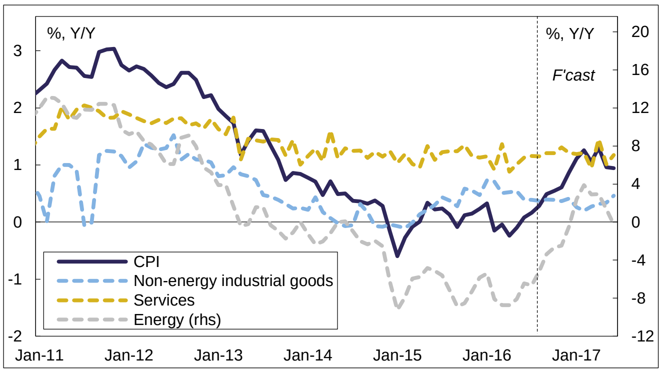
**Forecasts for Germany and Italy. Source: Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.*

Euro area: Interest rates on new SME loans*



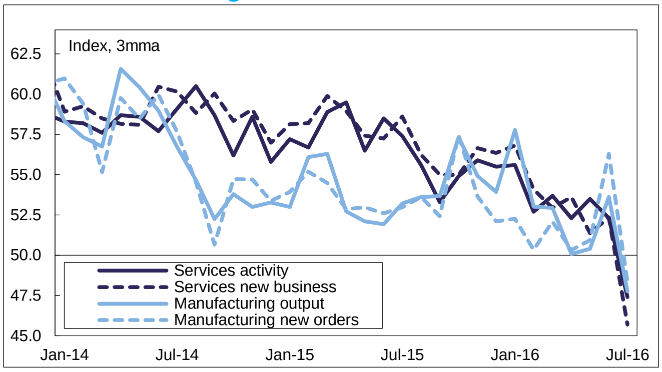
**Average interest rate on loans of up to €1mn for up to one year to non-financial corporations. Source: ECB, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Euro area: Inflation and forecast



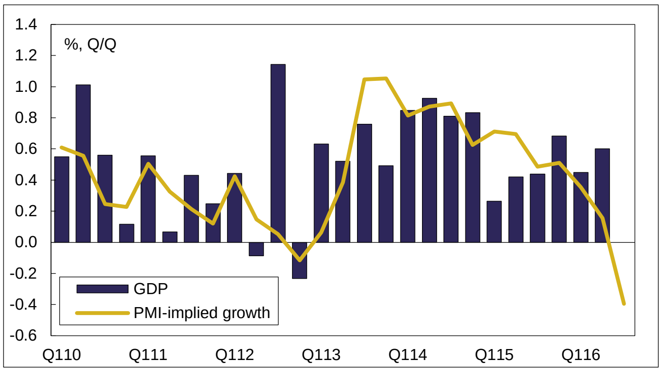
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing and Services PMIs



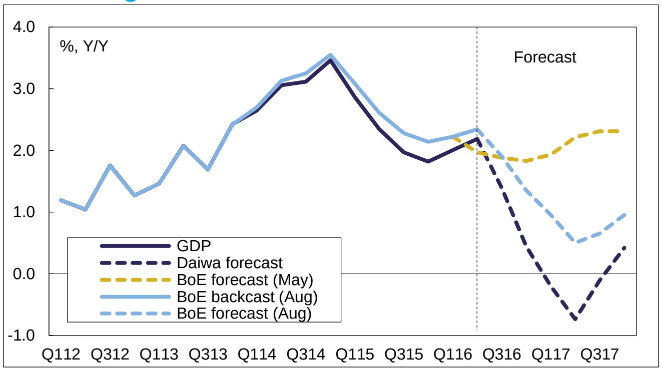
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP and PMIs*



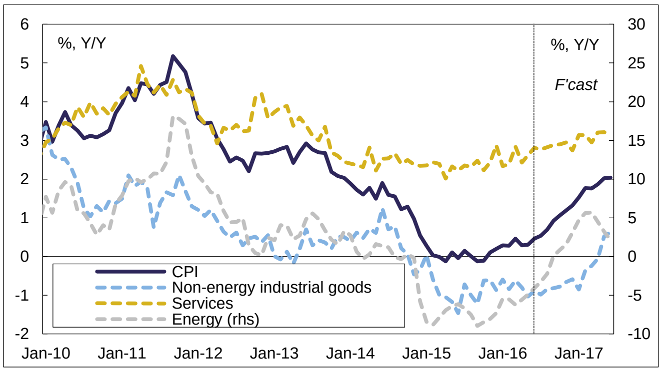
**July PMIs represent Q3 reading.*
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP growth and forecast



Source: BoE, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Inflation and forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Economic Research
Key contacts

London		
Head of Research	*Grant Lewis*	+44 20 7597 8334
Head of Economic Research	*Chris Scicluna*	+44 20 7597 8326
Emerging Markets Economist	*Saori Sugeno*	+44 20 7597 8336
Economist	*Emily Nicol*	+44 20 7597 8331
Associate Economist	*Mantas Vanagas*	+44 20 7597 8318
Research Assistant	*Danielle Pettet*	+44 20 7597 8332
New York		
Chief Economist	*Mike Moran*	+1 212 612 6392
Junior Economist	*Lawrence Werther*	+1 212 612 6393
Hong Kong		
Economist	*Kevin Lai*	+852 2848 4926
Research Associate	*Christie Chien*	+852 2848 4482
Economic Assistant	*Junjie Tang*	+862 2773 8736
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

DAIR <GO>

All of the research published by the London and New York research teams is available on our Bloomberg page at DAIR <GO>. If you are unable to access the research on this page, please contact Danielle Pettet on +44 207 597 8332.

Access our research blog at:
www.uk.daiwacm.com/blog

Follow us
@DaiwaEurope