Europe Monthly

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Overview

Euro area economic growth in Q3 looks to have been maintained close to the average rate of the recovery so far, with a similar pace looking on the cards over the near term too. But while inflation is set to pick up over coming months, lacklustre labour cost growth means that CPI will remain well below target for the foreseeable future. So, while uncertainty over the future direction of ECB policy has recently contributed to investor unease, we still expect the Governing Council to agree an extension of QE beyond next March, albeit possibly at a slower rate of asset purchase.

In the UK, there is relief that a marked contraction in output has been avoided for now. But the economic outlook is still weak with Brexit-related uncertainty set to take its toll. So, while inflation is set to rise steadily due to sterling weakness, further BoE monetary easing cannot be excluded. And with the government seemingly still having no idea how to implement Brexit without damaging the economy, the UK experience is likely to represent a cautionary tale for voters elsewhere across the EU, whom populist politicians are increasingly trying to seduce.

Key issues

After an unusually calm summer for global financial markets, investors recently became more uneasy about the outlook for major central bank policy. And the failure of **the ECB** on 8 September to make a clear commitment to prolong its asset purchase programme beyond next March – and Draghi's subsequent confirmation that a possible extension of the programme wasn't even discussed – added to the sense among some observers that global monetary easing might be approaching its limit. But while a Fed rate hike by year-end still looks more likely than not, ECB policy will not be tightened yet. Despite the failure to announce an extension of QE, Draghi's tone in September has remained dovish, emphasising the readiness of the ECB to provide more monetary policy support if needed to steer inflation back to target. And with the ECB now undertaking a review of *'options to ensure a smooth implementation'* of QE, there will clearly be substantive news on the purchase programme over coming months. Indeed, when the ECB's Governing Council discusses the conclusion of that review, most likely at the December policy meeting, we expect it to confirm the extension of QE beyond March.

Whether the ECB will keep buying assets beyond March *at the current rate* of €80bn per month, however, will depend on how economic and financial conditions evolve. Without meaningful new fiscal stimulus, the economic outlook is likely to remain underwhelming. But while there remains no sign that countries with scope to provide a fiscal boost are ready to do so – most notably with the German government remaining committed to its *'schwarze Null'* balanced budget target – if the economy proceeds broadly as the ECB expects, policymakers might well dare to slow very slightly the rate of asset purchases at some point next year. A weakening of the economic outlook, however, would not be a surprise. And with Draghi having noted that the maintenance of very easy financial market conditions is a necessary, if not sufficient, condition for inflation to rise steadily over the coming two years, the higher that bond yields rise or the more that investors fret about the health of certain banks in Germany or Italy, the less likely the ECB will be to trim back its asset purchases.

In the UK, following a marked deterioration in economic sentiment in the aftermath of the referendum, recent surveys and data suggest that, while growth is slowing, near-term recession is likely to be avoided. Indeed, **the BoE** has acknowledged that the economy has been stronger than it expected in August when it announced a package of stimulus measures, including a cut in Bank Rate to a record low of 0.25% and a resumption of net asset purchases. So, the near-term prospect of further monetary easing in the UK, while certainly still not to be excluded, has diminished.

But while there is relief that a marked contraction has been avoided for now, the UK's economic outlook still looks weak as Brexit-related uncertainty will deter new business investment and job creation. Indeed, there remains a huge vacuum where a meaningful Brexit policy should be with the government seemingly having no idea how to withdraw from the EU and regain control on immigration without inflicting severe economic damage. And not least due to the multi-dimensional relationships between the UK and EU that must be redesigned, the complexity of the existing rules governing European and global trade, the ability of other countries to veto whatever the UK government has in mind, and the lack of pre-referendum planning, it is going to be a very long time before firms and investors can have a clear idea about what Brexit will actually mean in practice.

As in the UK, the rise of **populism** elsewhere in Europe could have significant economic consequences. In Germany, two humiliating defeats for Merkel in early September in regional elections strongly suggest that the government to emerge following next year's general election will be politically weak. That could undermine the ability of Germany to take assertive decisions on a range of issues related to Brexit, Greek debt relief, and domestic, EU and euro area reforms. But elsewhere in the euro area things are not entirely going the way of the populists. In Spain, with economic recovery well maintained, polls suggest that the establishment centre-right Partido Popular is regaining support and might be able to form a workable majority government if, as looks likely, new elections are held in December. And while in Italy PM Renzi's position appeared to be weakening ahead of a crucial December referendum on constitutional reform, the shambolic governing of the populist Five Star Movement's Mayor in Rome might, for now at least, have undermined its support nationwide. So, risks of a troubling early Italian general election – which would have added further fuel to financial market volatility – might be receding.

Euro area

Euro area GDP growth slowed in the second quarter to 0.3%Q/Q, the softest pace for two years. While growth in Q1 was downwardly revised by 0.1ppt to 0.5%Q/Q, the Q2 annual rate was unrevised at 1.6%Y/Y, still a six-quarter low. GDP growth was overwhelmingly driven by net trade in Q2, with exports rising more than 1%Q/Q to contribute ½ppt to quarterly growth, while imports were up less than ½%Q/Q as domestic demand slowed notably. Private consumption growth moderated by 0.4ppt to just 0.2%Q/Q, the weakest since the start of 2014, while government spending growth was the softest in six quarters and private sector capex was unchanged. So, domestic demand only just managed to contribute positively to growth for the thirteenth consecutive quarter. In the absence of the drag from inventories, however, the euro area economy would have expanded in Q2 at a rate just above the average of the recovery to-date. And having subtracted from growth for the second successive quarter, stock-building seems less likely to act as a drag over coming quarters.

Euro area economic data for Q3 have been mixed, with a strong start to the quarter for retail sales and construction output (both up more than 1%M/M), but a weak showing for industrial production (down more than 1%M/M). Economic surveys have also provided confusing messages with September's preliminary Commission's euro area consumer confidence indicator and German Ifo business climate indices stronger but the flash composite PMI for the same month signalling a possible significant loss of momentum. On balance, however, euro area GDP growth in the third quarter looks set to be close to the 0.3%Q/Q rate of Q2. At the country level, German growth similarly looks set to be close to the 0.4%Q/Q rate recorded previously and Spain seems likely to lead the way among the large member states with growth near Q2's 0.8%Q/Q rate. But while French data indicate expansion in Q3 following a flat second quarter, growth in Italy is likely again to be weak.

The ECB currently expects **full-year euro area GDP growth** this year to be a touch softer than last at 1.7%, and marginally weaker still in the coming two years. It also expects headline inflation to rise from an average of just 0.2%Y/Y in August to above 1%Y/Y early next year as the impact of past shifts in the oil price wears off, and then to rise above 1½%Y/Y from early 2018. We are more downbeat. We forecast GDP growth to slow to below 1½%Y/Y in each of the coming two years. And given the absence of any cost pressures from the labour market, we expect inflation to remain subdued. Indeed, while we also forecast CPI to rise above 1%Y/Y in early 2017, we think it will struggle to beat 1½%Y/Y for the foreseeable future. Nevertheless, if financial conditions remain highly accommodative, the expected shift in inflation above 1%Y/Y in early 2017 might be sufficient to persuade the ECB to start to reduce the pace of its asset purchases from €80bn per month once that programme has been extended beyond March.

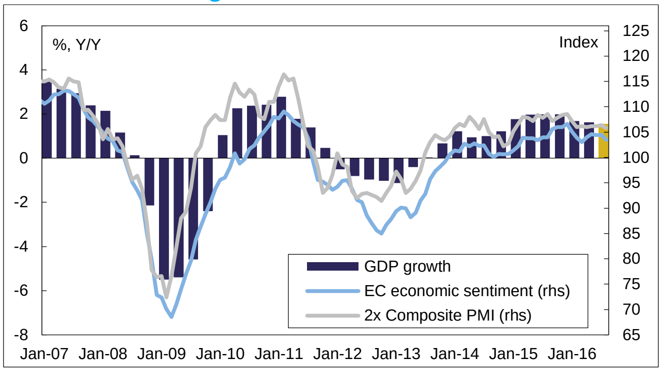
UK

Data for UK economic activity released since the referendum have surprised on the upside. After strong consumption helped GDP growth rise 0.2ppt to 0.6%Q/Q in Q2, retail sales have been firm, up about 2%M/M in July before broadly stabilising in August to stand about 6% higher than a year earlier. Industrial and construction output, meanwhile, were effectively flat at the start of Q3. And while surveys, not least the PMIs, signalled a marked deterioration in economic confidence in July, they suggested at least some of the lost ground was subsequently recovered. Nevertheless, employment was down more than 100k in July and wage growth slowed. And crucially, there remains limited data about the impact on the services sector or business investment, both of which might be expected to be hit by Brexit uncertainty. Taken in the round, the evidence still suggests that, while recession has been dodged, economic growth has slowed. In particular, GDP growth in Q3 might well have moderated to around 0.3%Q/Q. And we expect GDP growth to slow further to reach just 1.0%Y/Y in 2017, as Brexit concerns hit business investment, while weaker real income growth and increased unemployment weighs on consumption.

The latest **UK inflation figures** surprised on the downside with headline CPI unchanged in August at 0.6%Y/Y, still the joint highest since the end of 2014. Core CPI was unchanged too, at 1.3%Y/Y, matching the average so far this year, with inflation of non-energy industrial goods – a broad category which should be sensitive to exchange rate movements – surprisingly falling to -1.2%Y/Y, the lowest in almost a year. Nevertheless, given sterling's roughly-10% depreciation in trade-weighted terms since the referendum, we continue to expect a gradual rise in inflation, to above 1%Y/Y by year-end, about 2%Y/Y by mid-2017 and more than 2½%Y/Y by end-2017. Having eased policy via a package of new measures in August, the BoE's MPC has since acknowledged that recent economic data exceeded its expectations and that near-term momentum might be stronger than it previously envisaged. However, the MPC also judged that a slowdown in business spending was likely underway and that "the contours of the economic outlook" have not significantly changed from August. Moreover, if the outlook in November, when the BoE publishes new forecasts, remains broadly consistent with the BoE's August projections, the majority of the MPC members signalled in September that – despite the expected rise in inflation over coming quarters eventually to above the inflation target – they still expect to vote for a further cut in Bank Rate to close to but above zero.

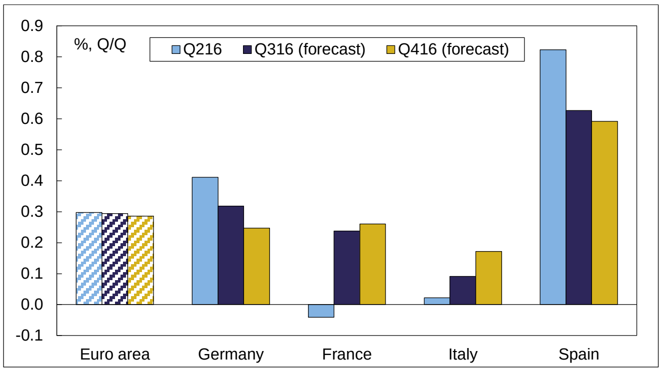
The UK government has confirmed that it will not trigger **Article 50** before year-end, not least as it awaits the outcome of court proceedings to determine whether a Parliamentary vote is required before it can be triggered. But there is no official timetable. And there are good reasons for why the government should want to wait well beyond the start of 2017 to trigger it. For example, the government has no plan for how it wants to approach the negotiations, even on the most basic of issues such as whether it wishes to remain within the EU Customs Union. PM May has indicated that she wants the government's approach to Brexit to have the backing of the devolved administrations in Scotland, Northern Ireland and Wales, which will be difficult (if not impossible) to achieve. Next year's general elections in France and Germany could also provide major complications for the negotiations. And ultimately the UK government will want to be in as strong a position as possible before triggering Article 50 – once it is triggered the UK's position will be weakened considerably. But there is plenty of pressure on Theresa May to act quickly, not least by Pro-Brexit ministers and pressure from other EU member states. And overall, it is still looks most likely to be triggered in the first half of 2017.

Euro area: GDP growth* & economic sentiment



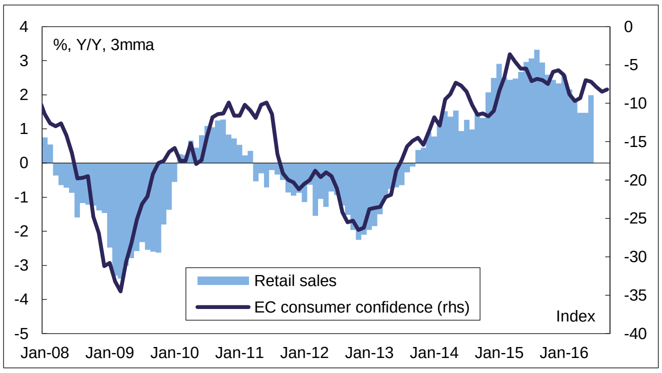
*Daiwa forecast for Q316. Source: Markit, Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area and member states: GDP forecast



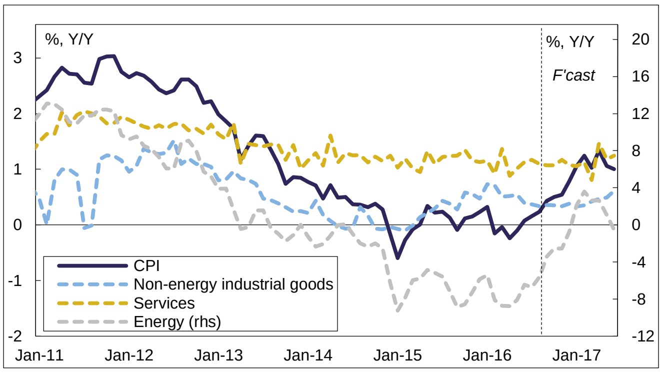
Source: Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales and consumer confidence



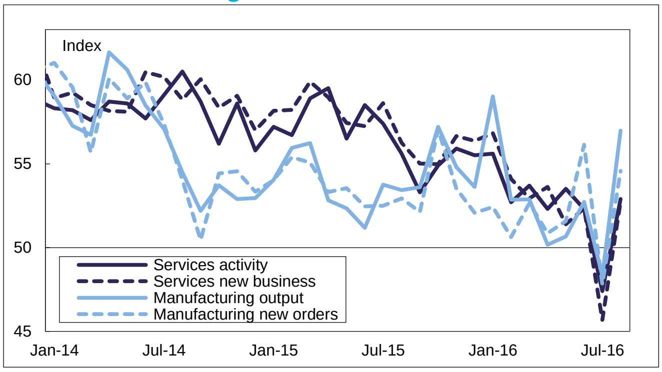
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation and forecast



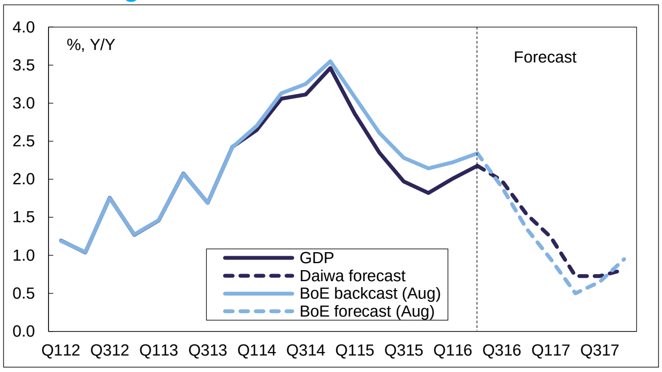
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing and Services PMIs



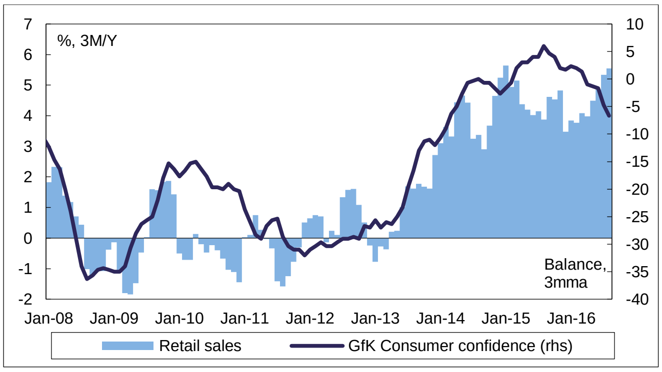
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP growth and forecast



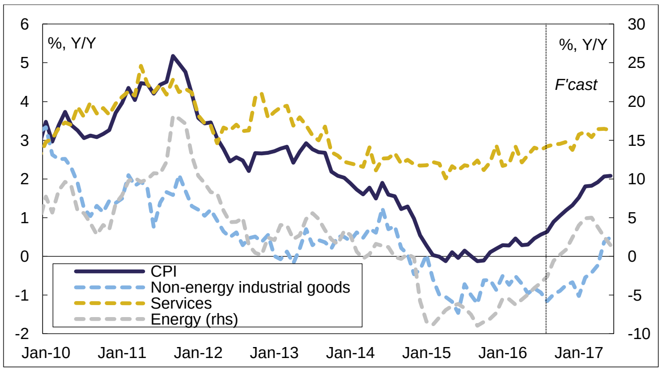
Source: BoE, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Retail sales and consumer confidence



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Inflation and forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

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