Europe Monthly

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

Mantas Vanagas
+44 20 7597 8318
Mantas.Vanagas@uk.daiwacm.com

Overview

Euro area economic growth in Q3 might well have been a touch stronger than in Q2, and surveys suggest a firm start to Q4. But while headline inflation is now picking up, underlying price pressures remain subdued and the ECB's inflation target will likely remain out of reach for the foreseeable future. We still expect the Governing Council to agree a six-month extension of QE beyond next March at the current rate of purchase of €80bn per month. And so, the ECB will need in December to relax some of the rules of the programme too.

In the UK, GDP growth likely slowed in Q3 to roughly half the rate in Q2. And the government's determination under Brexit to control immigration seemingly whatever the economic cost raises the prospect of significant slowdown ahead. As financial markets downwardly revise UK economic prospects, sterling continues to depreciate. And so, inflation is set to rise significantly over coming quarters, eroding real incomes and weighing on consumer spending at a time when economic uncertainty will hit business investment. So, we currently expect further BoE monetary easing in early 2017.

Key issues

Despite media speculation about whether it might be close to tapering its asset purchases, on 20 October **the ECB** predictably left its policy and forward guidance unchanged. So, its asset purchases will be maintained at the current rate of €80bn per month at least through to March, and its policy rates are expected to remain at present levels or below for an extended period and well past the end of QE. Following the meeting, Draghi made it clear that the future of QE – in terms of its extension beyond March, the amount of monthly asset purchases, and amendments to the programme rules to address bond scarcity concerns – will be decided at the December meeting alongside discussion of the ECB's updated economic forecasts.

To the evident surprise of some in the FX markets, which subsequently pushed the euro below $1.09 to a seven-month low against the dollar, Draghi's tone was dovish, as among other things he effectively ruled out an abrupt end to asset purchases. And his economic assessment provided cause to expect QE to be sustained at the current rate of €80bn per month beyond March. In particular, Draghi flagged the importance of the future path of core rather than headline inflation in guiding policy, and made clear that the ECB will look through any short-term increase in CPI related simply to 'blips' e.g. due to increases in the oil price. Draghi also acknowledged that 'there are no signs yet of a convincing upward trend in underlying inflation'.

While euro area GDP growth has been maintained close to the average rates of the recovery so far, the ECB's updated forecasts in December seem likely to push back the point at which the inflation target can be achieved on a sustainable basis to 2019 at the earliest. The ECB is also aware that the **risks to the euro area outlook** are still skewed to the downside, with no shortage of banana skins – many of them political in nature – to be dodged over coming months. Among the more notable, recent opinion polls suggest that voters will reject the Italian PM's constitutional reforms in a referendum to be held days before the next ECB policy decision, risking a political crisis in the euro area's most vulnerable large member state. In addition, in March, the Dutch general election similarly risks a swing towards the political extremes at a time when campaigning in the French Presidential election will also be well underway. And the economic and financial uncertainty surrounding Brexit seems likely to become more acute if and when the UK invokes Article 50 by end-March, as is PM May's current intention.

So, given that it would risk an unhelpful tightening of financial conditions, we certainly do not expect the ECB to start tapering for a while yet. Indeed, as we forecast core inflation to remain below 1½%Y/Y over the coming two years, an extension of the asset purchase programme at the current monthly pace of €80bn for a further six months to at least September 2017 would seem to be merited to give a further push to inflation towards target. To achieve those purchases, the ECB will also need to relax certain parameters of the QE programme, not least increasing the issue limit on bonds with no collective action clauses above 33%.

While it has revealed little about its objectives for the forthcoming negotiations with the EU over the precise form that **Brexit** will take, the UK government seems to have given priority to new controls on immigration over minimisation of economic costs. Indeed, many cabinet members have enthusiasm for the UK's exclusion from the EU single market and customs union, and are seemingly willing to risk the imposition of tariffs, non-tariff barriers and increased administrative burdens on exporting firms, and loss of access to EU customers for financial services. Faced with the possibility of such a damaging outcome, investors have inevitably revised down their perceptions of the UK economic outlook as reflected in sterling's depreciation, down more than 15% in trade-weighted terms since the referendum. And as the UK's huge current account deficit (about 6% of GDP in Q2) leaves it highly dependent on capital inflows from abroad, we expect sterling to weaken further.

Sterling's depreciation has dramatically altered the outlook for UK inflation, which now looks set to rise to about 1.5%Y/Y by year end, above the 2.0%Y/Y target in Q217, and close to 3.0%Y/Y by end-2017. But with wage growth set to remain subdued, real incomes will be squeezed resulting in a weakening of consumption while firms also cut their investment plans. As such, **the BoE** will look through the near term rise in inflation. And if there are signs of a further marked slowdown in growth by then, we expect the MPC to ease policy again in February with a further rate cut and further six-month extension of QE.

Euro area

Euro area GDP growth in the third quarter looks to have picked up slightly from the pace of the second quarter to match the 0.4%Q/Q average rate of the economic recovery. In line with the norm of the past couple of years, but contrasting with Q2, domestic demand looks to have been the main driver of the expansion in the third quarter while net trade likely subtracted from growth. Evidence of stronger consumer spending comes from data for euro area retail sales, which were on average 0.4% higher in the first two months of Q3 compared to Q2, and new car registrations, which rose 0.5%Q/Q in Q3 thanks to a strong September. In addition, while the recent profile has been very choppy, industrial production looks to have returned to growth in Q3 as the inventory adjustment that weighed in the first half of the year came to an end. Similarly, following a drop in the second quarter, construction output also likely grew in Q3 too. At the country level, German growth looks to have been maintained close to the 0.4%Q/Q rate recorded previously while Spain also posted the firmest growth among the large member states at close to the 0.8%Q/Q rate of the previous four quarters. Data also indicate expansion in France and Italy in Q3 following weak second quarters.

Economic surveys suggest that GDP growth should be maintained close to or above recent rates over the near term. Most notably, the October flash PMIs comfortably beat expectations with the euro area composite PMI posting its biggest gain in twenty-two months, up more than 1pt to 53.7, the highest level of the year so far. There was plenty of encouraging detail within the euro area survey too, not least the suggestion of the firmest rise in new orders since January, an increase in backlogs to the highest in more than five years, and an increase in employment above the average for the year to-date. The improvement at the start of Q4 appears to be led by Germany, where the manufacturing PMI rose to its highest since January 2014, the services PMI rose the most in almost four years, and the Ifo business climate index rose to its highest since April 2014. Separately, the Commission's flash consumer confidence index rose for the second successive month in October to suggest ongoing growth in euro area household demand, albeit likely at a more moderate pace than at the start of the year. And, among other things, surveys point to improved conditions in the euro area construction sector to their most favourable since the financial crisis.

While the near-term GDP growth outlook should be a source of reassurance for the ECB, the subdued **inflation outlook** is Draghi's main concern. Headline CPI rose in September to 0.4%Y/Y, the highest rate in twenty-three months due only to a smaller drag from energy prices which posted their smallest drop in twenty-two months. In contrast, inflation of services and non-energy industrial goods were unchanged from August, and so euro area core CPI remained stubbornly low at 0.8%Y/Y, stuck towards the bottom of the recent range, with the equivalent measures for each of the four largest member states close to or below the average of the past year too. Looking ahead, as energy inflation gradually turns positive, we expect headline CPI to rise gradually back above 1%Y/Y at the start of next year and to move a touch higher thereafter too. But we also expect core inflation to remain close to current rates over the near term not least on account of persistent large economic slack, which is keeping labour costs muted. Indeed, we currently forecast headline and core inflation to remain below 1½%Y/Y through to end-2018, and only a little higher in 2019, justifying an extension of ECB QE at the current pace for at least a further six months through to September 2017 at the earliest.

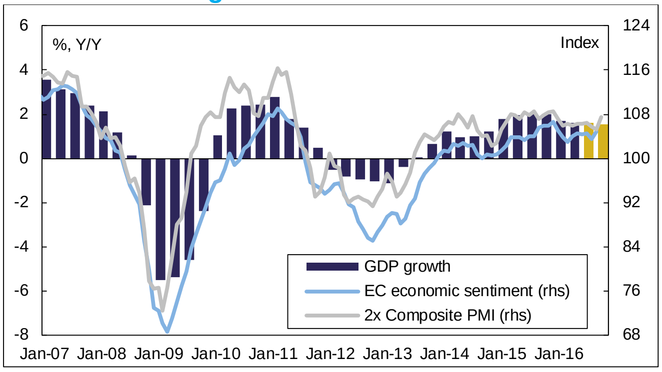
UK

While data for **UK economic activity** since the referendum have beaten expectations, they are also consistent with a slowdown that looks certain to become more marked over coming months. After strong consumption helped GDP growth rise 0.3ppt to 0.7%Q/Q in Q2, retail sales have been firm, up about 2%M/M in July before broadly stabilising in August and September to take growth over the third quarter as a whole to a vigorous 1.8%Q/Q. But, despite the boost to competitiveness from sterling's depreciation, manufacturing production – like exports – have been subdued, and an increase of more than 1%M/M in output is required in September to prevent total industrial production from falling in Q3. In addition, with construction output having fallen in August to its lowest level in twelve months, that sector also appears to have subtracted from growth in Q3. And while surveys, not least the composite PMI, which rose in September to the highest level since January, suggest improved economic confidence at the end of the quarter, taken in the round the evidence suggests that GDP growth in Q3 moderated to around 0.4%Q/Q. We expect GDP growth to slow further to 0.2%Q/Q or below in each quarter from Q416 through to Q217 as Brexit concerns hit business investment, while weaker real income growth starts to weigh on consumption. Overall, we forecast full-year growth in 2017 of just 1%Y/Y, about half the rate in 2016.

While economic growth is slowing, **inflation** is picking up, with the 0.4ppt increase in CPI to 1.0%Y/Y in September larger than expected. As in the euro area, some of the increase in inflation was related to a diminishing impact from past energy price declines, a trend that will continue to add to CPI in coming months. But there was also a notable rise in prices of clothing and footwear, which pushed core CPI up to 1.5%Y/Y, which, like the headline rate, was the highest in almost two years. Looking ahead, the sharp post-referendum depreciation in sterling is set to add significantly to both headline and core inflation as firms' currency hedges expire and the resulting higher import costs are passed on directly to consumers. We expect headline CPI inflation to rise to about 1.5%Y/Y by year-end, above the BoE's 2%Y/Y target by Q217 and to about 3%Y/Y by the end of 2017. But with average nominal wage growth unlikely to rise above the recent range as firms respond to heightened uncertainty and softer demand by shelving recruitment plans and shedding staff, the BoE will expect the increase in inflation to be temporary and will likely focus its efforts on cushioning the negative impact on demand via further monetary easing, in our view most likely in February.

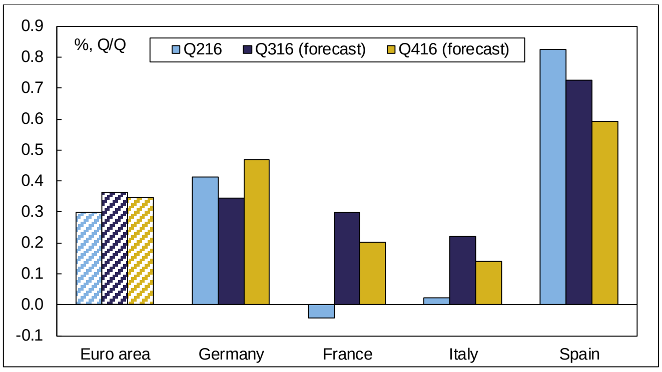
Looking ahead, we see the risks to inflation to be skewed to the upside, principally because we think that **sterling**'s depreciation is likely to have further to go. The negative impact of Brexit on UK external competitiveness, in the context of a country that before the referendum was already running a current account deficit of 6% of GDP – the largest of any major economy – certainly implied the need for significant currency depreciation. And if and when the UK loses 'passporting' rights to sell financial services to EU customers – or if UK-based financial services firms simply decide to relocate activities abroad in the meantime in response to the mere risk of losing such rights – then the UK's underlying external deficit will be much larger, perhaps as much as 10% of GDP, requiring an even larger adjustment to sterling. So, while it is still unclear quite what Brexit will precisely mean in practice for various sectors, with the capital inflows from abroad required to finance the UK's current account – not least the large-scale FDI inflows typically associated in the past with UK participation in the EU single market – bound to be less forthcoming in a world in which significant doubts about the UK's economic prospects have been raised by the prospect of Brexit, the longer that PM May and some of her Ministers appear unconcerned about the economic costs and maintain their unpleasant and self-defeating rhetoric against foreign workers and global capital, the further sterling is likely to fall.

Euro area: GDP growth* & economic sentiment



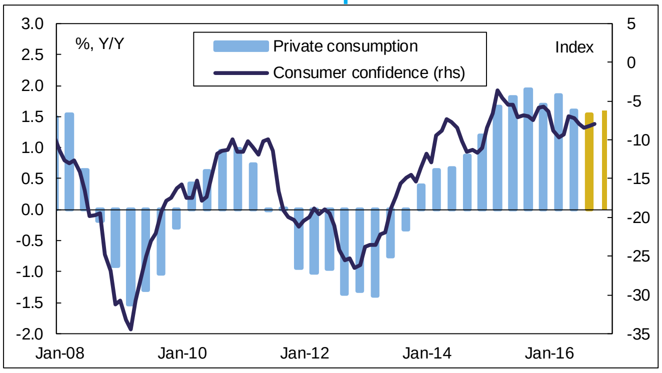
Daiwa forecast for Q316 and Q416. Source: Markit, Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area and member states: GDP forecast



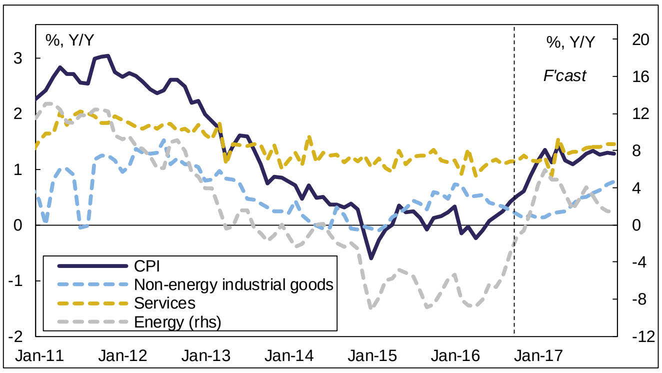
Source: Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Private consumption* and confidence



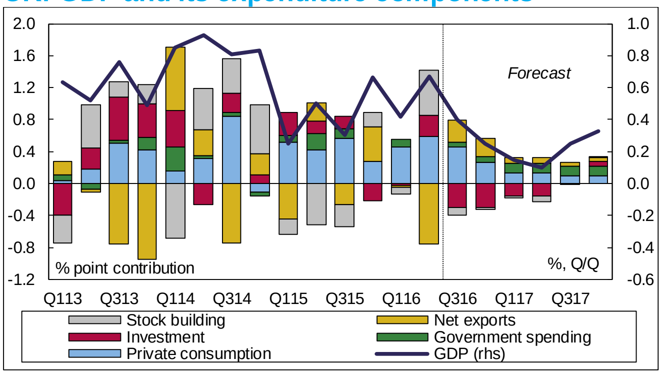
**Forecast for Q316 and Q416.*
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation and forecast



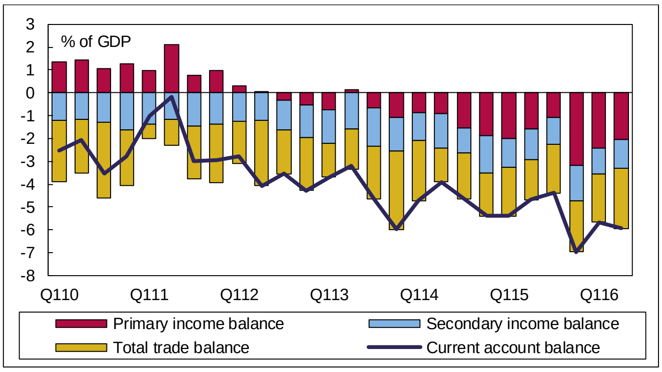
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP and its expenditure components



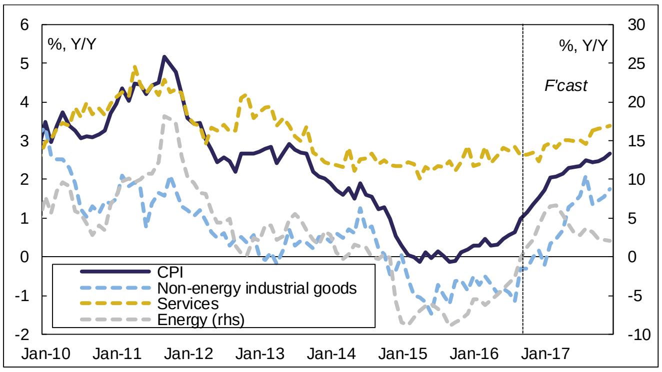
Source: ONS, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Current account



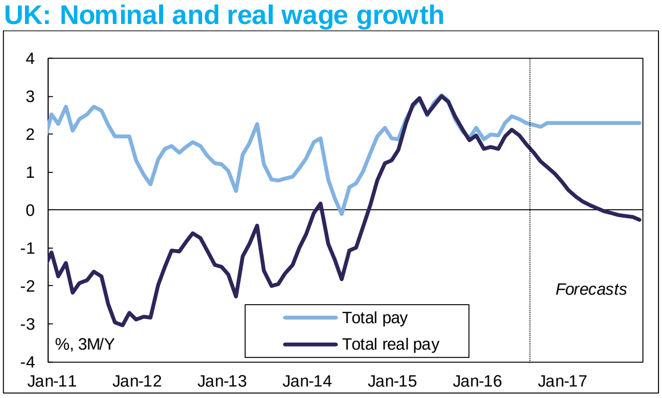
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Inflation and forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Nominal and real wage growth



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

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