United Kingdom

- **Growth should remain sluggish this year and next given Brexit-related uncertainty and reduced global growth prospects. Alongside depressed economic growth and below-target inflation, we expect the BoE to remain on hold until Q3-2020.**

The UK economic outlook remains unambiguously binary. On one side is our baseline forecast: an orderly exit from the European Union—with bouts of political uncertainty on the way to its formalisation—where growth remains relatively sluggish in the near-term as the British economy adjusts to a post-Brexit world. In the opposite direction is a 'hard-Brexit' where an undevised break-up of political and economic ties with continental Europe pushes the UK into a recession in the latter part of 2019.

After cutting it close to a no-deal divorce on April 12, the EU has granted the UK a delay on its exit from the bloc until as late as October 31—with a compliance-check scheduled at the end of June—after PM May's agreement with the EU, and various alternative proposals to the EU-split, were rejected on multiple occasions by Parliament. Given the steep economic costs of a 'hard-Brexit', we continue to expect that sense will prevail in the UK and lawmakers will settle on a negotiated process for separation. Political uncertainty should remain elevated, however, given the possibility that the UK will negotiate with the EU under new leadership; PM May's time at the helm of the British government may be nearing an end due to a resounding failure to garner enough support for her deal with the EU.

While economic sentiment continues to worsen among households, rapidly rising wages and falling inflation have led to a sustained expansion in retail spending since summer 2018 (chart 1). Non-fuel retail sales volumes have risen by an average of 3.6% y/y since May 2018 in tandem with a 3.2% y/y average increase in wages during the same period on the back of the lowest unemployment rate in over forty years. Nevertheless, we anticipate that economic uncertainty, as well as slowing job creation, will begin to feed into reduced consumer spending growth in 2019 as households bolster their savings.

We forecast that GDP growth in the UK will reach a cycle bottom of 1.1% in 2019 before ticking up slightly in 2020 to 1.2%. Following last year's economic expansion of 1.4%, slower growth will follow in 2019 as business investment—which contracted through each quarter of 2018—is projected to decline for a second consecutive year, bogged down by Brexit-related uncertainty and reduced global growth prospects. A jump in government spending, principally on health, should, however, provide a boost to growth in the near term against declines in capital expenditures and household consumption.

Under our current baseline which considers an orderly exit from the European Union accompanied by sluggish growth through the forecast horizon, we expect the Bank of England to increase its policy rate only once in the second quarter of 2020 to 1.00%, up from 0.75% currently. We anticipate that inflation in the UK will not return to the BoE's 2% target prior to 2020 as falling energy prices and the fading impact on domestic prices from past GBP depreciation, as well as the fact that British economic output remains a tad below potential, are set to offset the upward pressure of rising wages on consumer prices.

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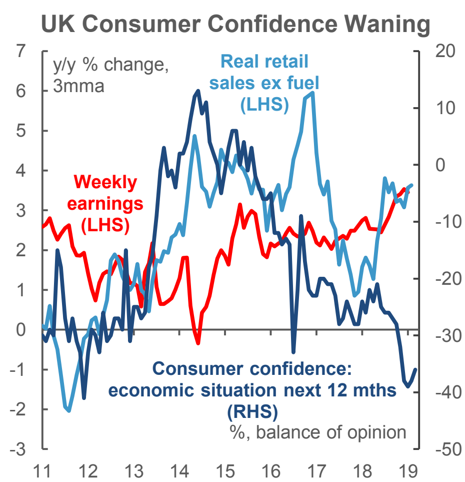
United Kingdom	2017	2018	2019f	2020f
Real GDP (annual % change)	1.8	1.4	1.1	1.2
CPI (y/y %, eop)	3.0	2.1	1.9	2.0
Central bank policy rate (%, eop)	0.50	0.75	0.75	1.00
UK pound (GBPUSD, eop)	1.35	1.28	1.40	1.45

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Gfk, ONS.

Eurozone

- **We forecast that Eurozone real GDP growth will slow in 2019 owing to global trade and geopolitical uncertainty as well as certain transitory factors impacting the European industrial sector.**
- **The ECB is expected to maintain its accommodative monetary policy with no policy rate increases projected through our forecast horizon amid sluggish growth and subdued inflation.**

Growth prospects for the Eurozone have worsened of late as country- and sector-specific issues disrupted the bloc's economic expansion in the second half of 2018, while the risk of US auto tariffs and a 'hard' Brexit loom negatively over business sentiment in the region. The weaker Chinese outlook will continue to dampen growth in the euro bloc, though we consider that Chinese policy measures will have good traction on that economy through 2019. We forecast real GDP growth in the Euro Area to slow to 1.1% in 2019, after 2018's pace of 1.8%, before picking up to 1.5% in 2020.

Despite adverse external factors weighing on the outlook for the European manufacturing sector, domestic demand in the Eurozone remains resilient on the back of steady job gains and accelerating wage growth, with the unemployment rate currently sitting at a post-financial-crisis low. Activity readings for the service sector—which accounts for about three-quarters of economic output in the bloc—have ticked up recently in opposition to manufacturing production (chart 1). In spite of declining economic sentiment, business investment should stay solid in 2019 as industrial operating rates remain significantly above their recent long-term average in the euro bloc (chart 2).

Fiscal loosening is set to boost growth in 2019 in the face of softening economic activity (chart 3). A 100-euro/month increase in employment bonuses for minimum -wage workers in France kicked in on January 1 among other measures deployed to counter civil unrest, while the Italian government aims to cut taxes and expand welfare outlays in their upcoming budget. The German federal government has also revised upwards its planned investment outlays for 2019, and has signaled that it would table a bill introducing tax incentives for R&D, though it remains strongly opposed to fiscal deficits.

Germany, the euro-bloc's largest economy, has experienced a sharp deterioration in exports, due in part to one-time production issues in the auto sector but also owing to economic woes in some of its principal trading partners. New vehicle emission standards in the EU which came into force in September 2018 caught German automakers flatfooted, forcing them to suspend assembly of non-compliant vehicles ahead of the new regulations (chart 4). Though we expect German auto production—which also disrupted upstream manufacturing sectors—to normalise in the coming months, reduced demand for vehicles amid slower growth in the continent should keep assembly levels subdued. France and Italy will similarly face losses from a global economic slowdown, but domestic issues—such as the 'gilets jaunes' protests in France and the lingering impact on business and consumer confidence of the months-long EU-Italian battle over fiscal restraint—will likely compound external headwinds.

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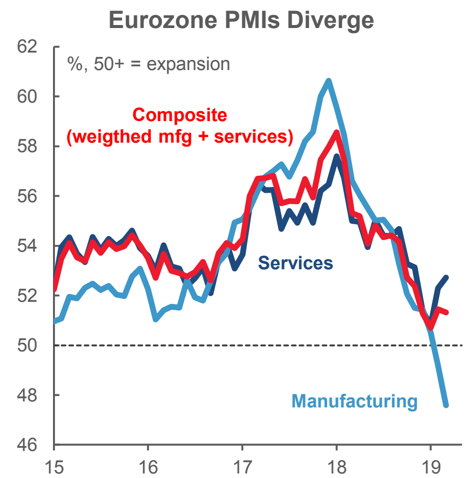
Eurozone	2017	2018	2019f	2020f
Real GDP (annual % change)	2.4	1.8	1.1	1.5
CPI (y/y %, eop)	1.3	1.5	1.2	1.6
Central bank policy rate (%, eop)	0.00	0.00	0.00	0.00
Euro (EURUSD, eop)	1.20	1.15	1.20	1.24

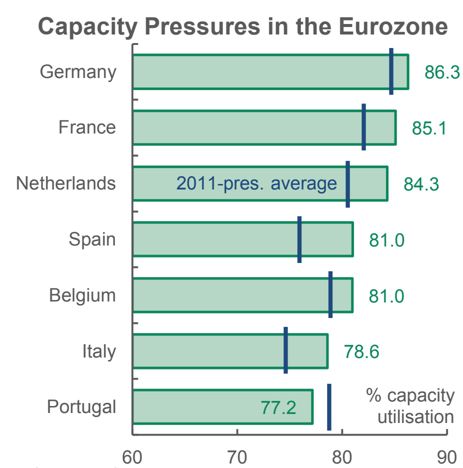
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IHS Markit.

Chart 2

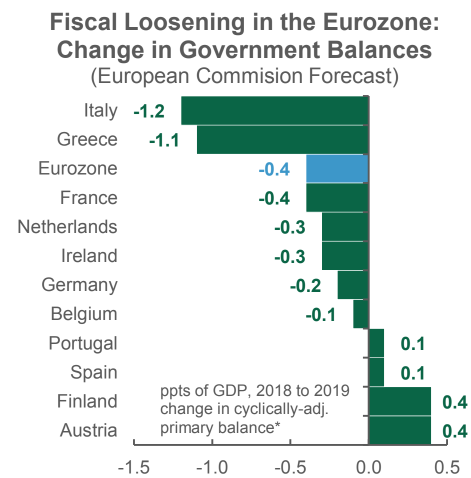


Sources: Scotiabank Economics, national statistics agencies.

We forecast that Eurozone HICP inflation will decelerate from 1.8% in 2018 to 1.2% in 2019, well beneath the ECB's target of 'below, but close to 2%'. After averaging 2.1% y/y from May to October last year, inflation in the euro area has markedly decelerated since November 2018 following a drop in energy prices (chart 5). While international oil prices have picked up since late-December, we anticipate that these gains will have only a short-lived impact on consumer prices: our latest forecast calls for Brent oil to average $67/bbl in 2019, down from $72/bbl in 2018. Prices excluding food and energy rose by only 0.8% y/y in March and are not expected to materially move the needle on headline inflation this year. Nevertheless, 'supercore' inflation has been on a steady upward trajectory since 2015 and may accelerate further on the back of rising employee compensation (chart 6).

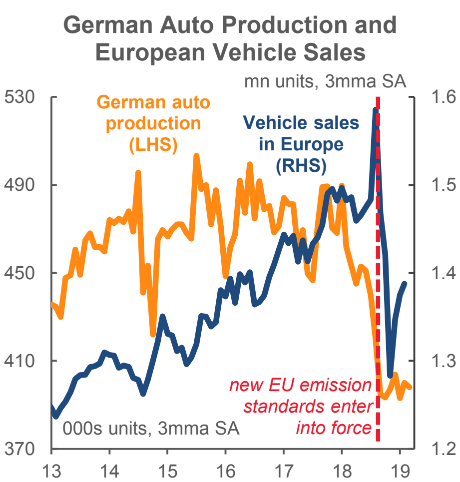
In light of weaker growth and subdued inflation, we believe that monetary policy will remain considerably accommodative in our forecast horizon, with the ECB's main refinancing and deposit facility policy rates set to remain unchanged at 0.00% and -0.40%, respectively, through 2019 and 2020. The ECB will also launch a third round of long-term loans to banks to maintain favourable credit conditions in the Eurozone beginning in September 2019, and will continue to reinvest funds from maturing securities acquired under its asset purchase programs which ran from March 2015 until December 2018.

Chart 3



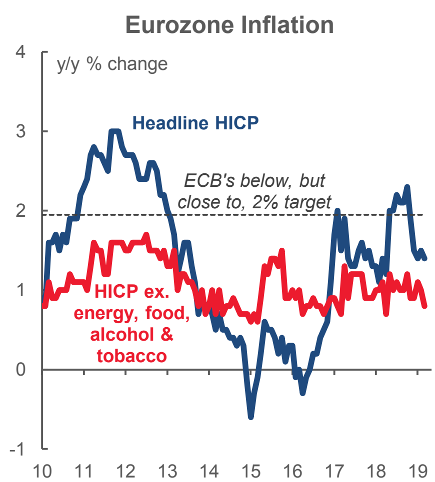
Sources: Scotiabank Economics, European Comm.
*fiscal balance that would apply under current policies if economy were at potential output, i.e. absent cyclical expenditure and revenue patterns.

Chart 4



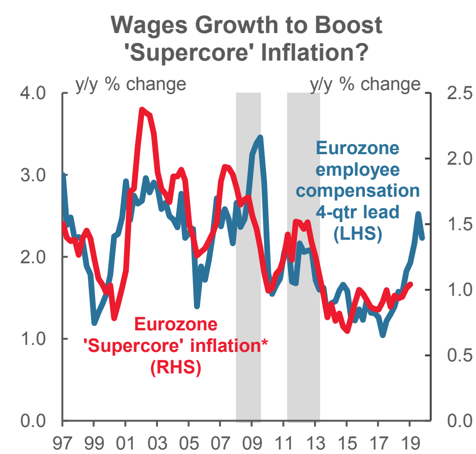
Sources: Scotiabank Economics, VdA.

Chart 5



Sources: Scotiabank Economics, Eurostat.

Chart 6



Sources: Scotiabank Economics, Eurostat, ECB, Haver Analytics.
*consumer prices excluding energy, food, alcohol, tobacco, air transportation, and packaged holidays (~2/3rds of headline basket).