Economic Research

May 2021

Market Monitor – Eurozone

Eurozone Troubled by High Levels of Debt

The economy slid into a double-dip recession

Eurozone slid into a double-dip recession as Q1 GDP contracted by 0.6% quarter-on-quarter, followed by a 0.7% contraction in Q4 2020. Its economic performance is starkly lagging behind other major economies. Annual inflation for the eurozone was 1.3% in March, up from 0.9% in February. Retail sales rose by 3% MoM in February, following a 2.9% drop in the previous month. However, rising numbers of Covid-19 cases have prompted a wave of school and business closures and will weigh on consumer sentiment. Industrial production marked a return to contraction, with a 1% month-on-month drop in February. France and Malta saw the largest fall. This reflected the impact of Covid-19 restriction measures and soaring import prices due to shipping container shortages and semiconductor supply chain disruption across the eurozone.

The EU's Covid-19 vaccination progress has been stuttering, with indecisiveness and ineffectiveness casing the bloc to trail its US and UK counterparts by some margin. Supply constraints and public hesitation have further exacerbated the situation. By 30th April, 24% of the EU population had received at least one dose of Covid-19 vaccine, in contrast to about 43.3% of the US and 50.6% of the UK.

Despite all the unfavourable figures, the EU purchasing managers' index showed surprising strength. The preliminary reading of the composite PMI rose to 53.7 in April, up from 53.2 in the previous month. Meanwhile, the manufacturing PMI rose from 62.5 to 63.3, whereas the services PMI increased from 49.6 to 50.3. Optimism prevailed with a belief that mass re-opening is drawing near.

- **PMIs show surprising strength despite rising Covid-19 cases and lag in vaccinations.**
- **Slow delivery of rescue funds could be a problem for highly indebted nations.**
- **European shares gained with bets of an economic recovery, while euro is lifted by a weaker US dollar.**

High levels of national debt could spell future debt crises

Having shored up their economies with massive fiscal stimulus to endure the Covid-19 pandemic, eurozone governments are now facing financial strain. Total government deficits have risen sharply to EUR 820 trillion (7.2% of GDP) in 2020, up from EUR 75.4 trillion (0.6% of GDP) in 2019. Spain, Greece, and Italy – which are already highly indebted – had the highest deficits last year, with the ratio to GDP ranging from 9.5% to 11%.

Government debt-to-GDP ratios in the bloc increased to 98% at end-2020, up from 83.9% a year earlier. In particular, Greece's borrowed loans reached 205.6% of GDP. A sharp global sell-off in the bond markets, as seen since mid-February, might raise borrowing costs and spell debt trouble for the currency bloc.

Countries have been waiting for distribution of €750 billion in funds from the EU's recovery plan, also known as Next Generation EU, which was agreed in July last year, where Spain and Italy were the main beneficiaries. While the US had already distributed its remarkable US$1.9 trillion stimulus package, the EU was still in the discussion stage. Impatience is building, especially in countries that sorely need the funding. The market generally expects the first tranche of rescue funds to come through in July, which is the most optimistic scenario. Any significant delay will drag the economic recovery and risk another sovereign debt crisis.

European stocks see gains amid global economic revival

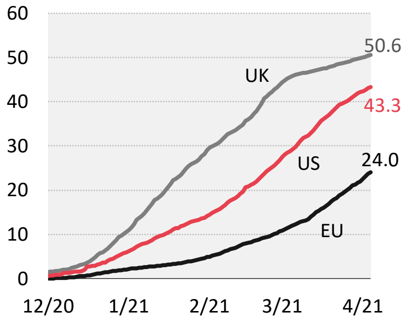
European shares continued to benefit from hopes of an economic rebound, while expectations of a subsequent rise in borrowing costs globally have rendered financial stocks more attractive. The pan-European Stoxx 600 Index hit 442.49 in mid-April, surpassing the pre-crisis peak of February last year. The index had risen 1.8% between end-March and end-April. Meanwhile, the German DAX Index was up 0.8% and France's CAC Index was up 3.3%.

Government bond yields rise

The market showed little reactions towards the positive ruling by Germany's constitutional court concerning passage of the EU recovery fund. Improving economic data in the eurozone and a smoother vaccination programme has raised hopes that the region's recovery is in sight and increased investors' risk appetite. Government bonds became less attractive and saw yields edge higher. Meanwhile, the European Central Bank (ECB) held its monetary policy unchanged. The market is looking for clues of when the ECB will wind down its bond purchases in view of an improving economic outlook. By 30th April, German 10-year government bond yields had risen to -0.202%, up from -0.292% at end-March.

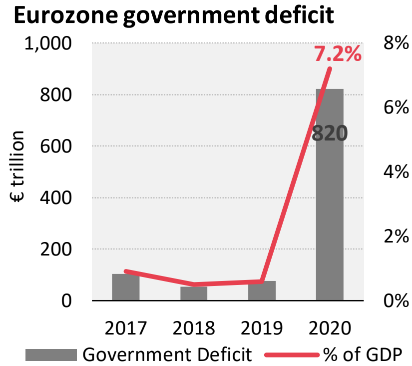
On 30th April, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German equivalents was about 1.1 percentage points, up from 0.96 percentage points at end-March.

Share of people receiving Covid-19 Vaccine (%)



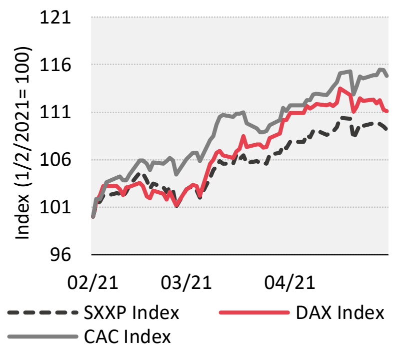
Source: Our World in Data, data as at 3/5/2021

Eurozone government deficit



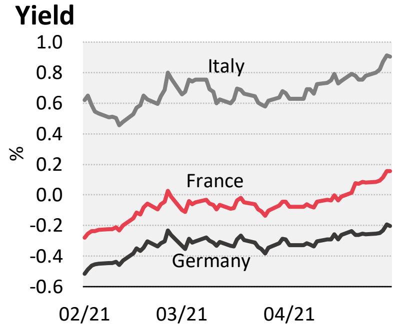
Source: Eurostat, data as of 23/4/2021

Stock Market Indices



Source: Bloomberg, data as of 3/5/2021

10-Year Government Bond Yield

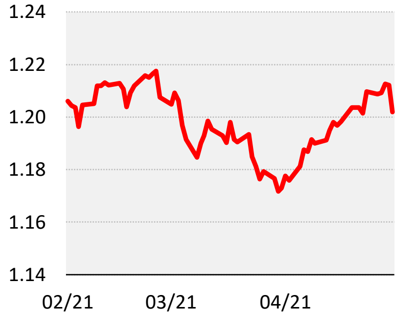


Source: Bloomberg, data of at 3/5/2021

Euro strengthens as US dollar weakens

The euro had risen by 2.5% against the US dollar as of 30th April and was trading at USD 1.202, compared with USD 1.173 as at end-March. The euro was mainly lifted by a weaker US dollar, following a dip in US treasury bond yields. The pickup in US inflation seems unlikely to change the Federal Reserve's current monetary policy. However, the slow pace of vaccinations and the EU's failure to bring the epidemic under control will limit the euro's rise.

Euro against USD



Source: Bloomberg, data as of 3/5/2021

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