BEA 東亞銀行

Economic Research

July 2022

Market Monitor – Eurozone

ECB Delivers Rate Hike Plan

ECB signals monetary normalisation plan

Eurozone inflation estimate accelerated further to a record high in June, rising by 8.6% year on year, up from 8.1% in April. In particular, energy prices registered double-digit growth for the 15th consecutive month, rising by 41.9% from a year ago. Prices of food, alcohol, and tobacco also accelerated further from 7.5% in May to 8.9% in June, partly reflecting the impact of the Russia-Ukraine conflict on major agricultural products.

Inflation continues to hit record highs, and is set to remain far above the European Central Bank (ECB)'s inflation target for the foreseeable future. Accordingly, the ECB announced at its June monetary policy meeting that it will officially end its asset purchase programme (APP) from 1st July, and could raise interest rates by 0.25% in July for the first time in 11 years. If inflation does not show signs of improvement, a 0.5% rate hike will be considered in September, followed by an orderly rate hike schedule thereafter. As such, the ECB is likely to end its negative interest rate policy as soon as the end of the third quarter.

As the ECB will normalise its monetary policy soon, and with the recent global financial market volatility, some indebted member states are facing an increased pressure of rising borrowing costs. In order to alleviate the risk of financial fragmentation, the ECB will apply greater flexibility to reinvest maturing securities under the Pandemic Emergency Purchase Programme (PEPP), with a view to preserving the functioning of the monetary policy transmission mechanism.

Eurozone economy shows signs of weakening

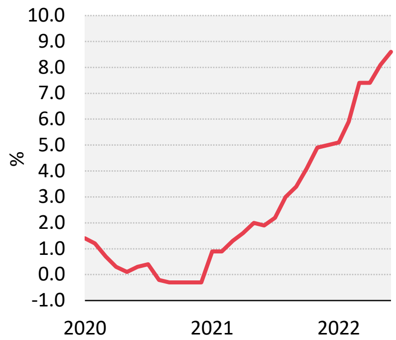
In recent months, the eurozone's economic indicators have somewhat weakened, showing the emerging impact of the Russia-Ukraine conflict, surging energy and food

ECB signals the first rate hike action in Q3 in more than a decade.

Eurozone economy weakens amid multiple shocks from Russia-Ukraine conflict, surging prices, and supply disruption.

Financial markets decelerate with expectation of aggressive tightening environment.

Eurozone Inflation



Source: Bloomberg, data as of 1/7/2022

prices, and supply chain disruptions. Notably, Germany recorded a weaker performance in its industrial and retail sector.

Eurozone industrial production remained under pressure, rising by a lower-than-expected 0.4% month on month in April. Compared to the end of last year, industrial production decreased by 1.3%. Although German industrial production increased by 1.3% month on month in April, this has merely slightly offset the monthly drop of 4.5% in March and production remains 2.3% lower than at the end of 2021. Meanwhile, the eurozone manufacturing purchasing managers' index (PMI) also declined to 52.1 in June, down from 54.6 in May.

On the external front, the eurozone registered a trade deficit for the seventh month in a row, reaching a record €31.7 billion in April, likely driven by the elevated costs of imported energy. In comparison, the trade deficit in March was €17.8 billion. Imports increased by 7.1% month on month in April, significantly higher than the 3.2% growth seen in March. Exports increased by 1.5% in April.

Eurozone retail sales declined by 1.3% month on month in April, ending the uptrend of three consecutive months. Food, drinks, and tobacco sales registered a rather significant month-to-month fall of 2.6%. Meanwhile, German retail sales weakened in April, seeing a larger drop of 5.4% month on month.

Escalating geopolitical tensions could further disrupt energy supply

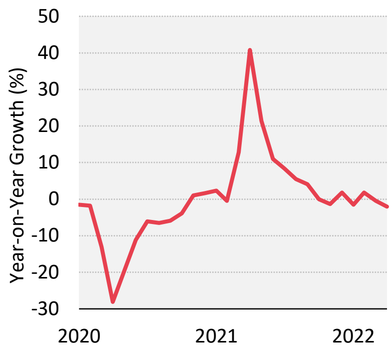
Europe is facing deepening worries about energy supply disruptions. In mid-June, Gazprom, Russia's state-owned natural gas company, announced that gas transmission to European countries through the Nord Stream pipeline would be cut by a further third. The reduction in Russian gas supply will further drive up the natural gas prices in Europe, hitting industries like chemicals and steel. Meanwhile, the EU could further expand the scope of sanctions on Russian energy to include oil imports. With a continually tight energy supply, inflationary pressure will remain elevated in the near future.

Looking ahead, the pandemic's impact could ease amid the reopening of cross-border and domestic economic activities. Nevertheless, rising uncertainties arising from the Russia-Ukraine conflict, supplies of energy, food, and key raw materials, accelerating monetary tightening by global central banks, and more volatility in the financial markets will continue to affect the eurozone's economic performance. In the face of rising challenges, household sentiment will turn cautious and consumers will prefer to save more rather than spend, possibly weakening the momentum of economic recovery.

Softening financial market performance amid faster global monetary tightening

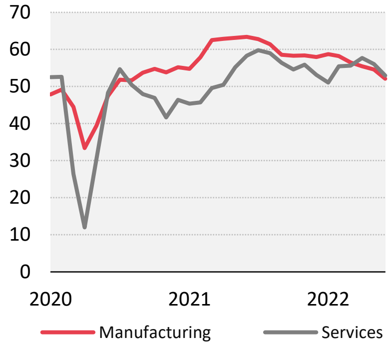
The more aggressive rate hikes and tightening path of the US Federal Reserve in June have fuelled worries of a global growth slowdown or even recession, causing risk-averse sentiment. European stock markets have plummeted over the past month. The pan-European Stoxx 600 index slumped by 8.2% in the period between end-May and end-June. The German DAX index tumbled by 11.2% during the same period, while the French CAC index fell by 8.4%.

Eurozone Industrial Production



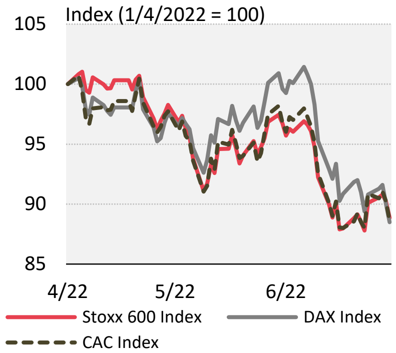
Source: Bloomberg, data as of 15/6/2022

Purchasing Managers' Index



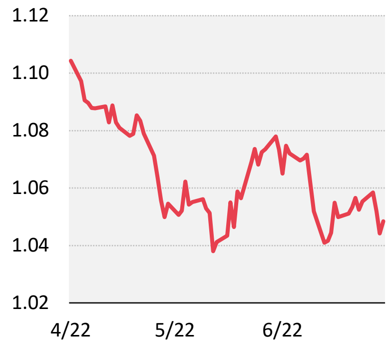
Source: Bloomberg, data as of 5/7/2022

Stock Market Indices



Source: Bloomberg, data as of 30/6/2022

Euro against USD

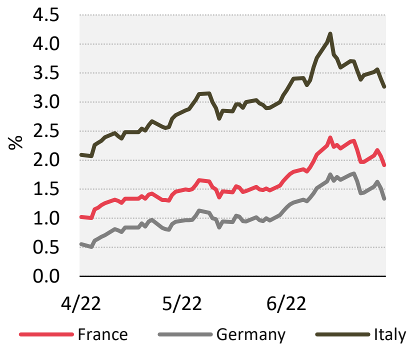


Source: Bloomberg, data as of 30/6/2022

Heightened market worries about a recession also resulted in a stronger US dollar. As of end-June, the euro traded at USD 1.0484, down 2.3% from USD 1.0734 as at end-May.

European government bond yields recorded an upward trend, with a wider expectation of rate hikes in Q3. As of 30th June, Germany's 10-year government bond yield increased to 1.336%, notably higher than the 1.122% seen at end-May. The extra yield demanded by investors to hold 10-year Italian bonds rather than their German counterparts had decreased slightly to around 1.9% as of end-June, down from around 2% at end-May, after the ECB announced it would take steps to alleviate the risk of financial fragmentation, that somewhat eased investors' worries over indebted countries.

10-Year Government Bond Yield



Source: Bloomberg, data of at 30/6/2022

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