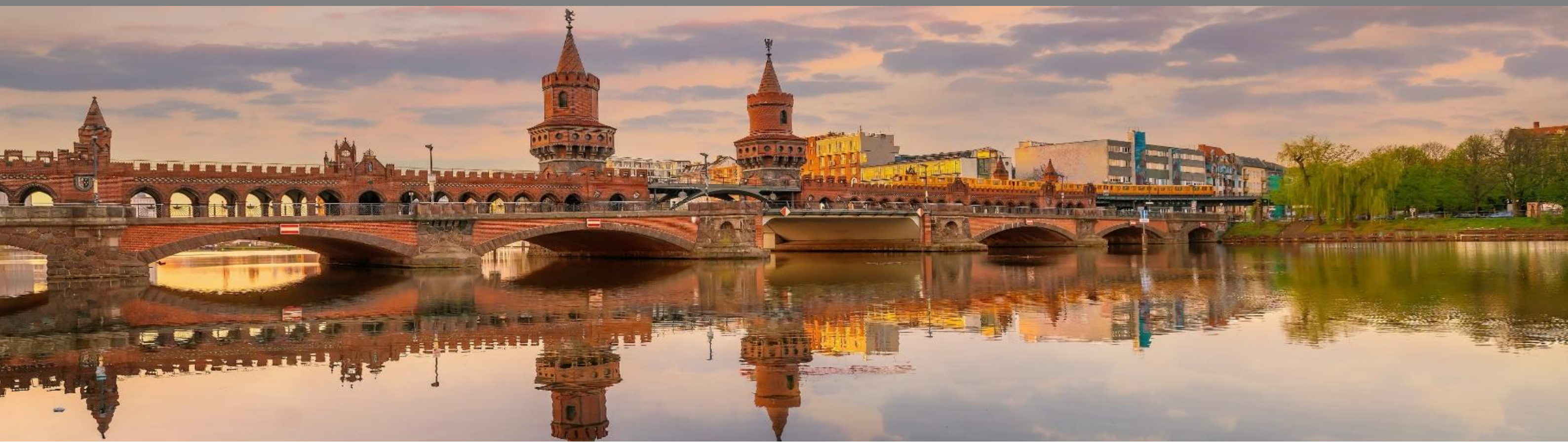
BEA東亞銀行

Economic Research

January 2023

Market Monitor – Europe

2023 European Economic Outlook remains Uncertain



Weak economic momentum persists in Europe

Geopolitical tensions, elevated inflation, and monetary tightening continue to plague Europe's economic growth. Although the UK economic growth rebounded by 0.5% month-on-month (MoM) in October 2022 due to the low comparison base for the extra holiday of the Queen's state funeral in September, the overall economic momentum remains weak. Retail sales in both eurozone and the UK did not see a significant improvement in November. Retail sales in eurozone rebounded by 0.8% MoM, but failed to offset the 1.5% decline in October; the UK fell by 0.4% MoM after a rebound of 0.9% in October. In addition, industrial production in eurozone turned from a monthly increase of 0.8% in September to a decline of 2.0% in October, while the UK's was flat in the same month. Various economic indicators showed that the European economic sentiment remains sluggish. Under the influence of geopolitical tensions, elevated prices, and rising borrowing cost, households' purchasing power and enterprises' production activities have been constrained, with the impact expected to linger until 2023.

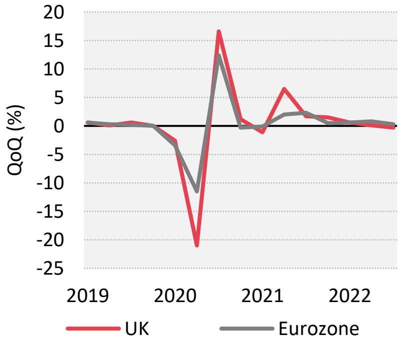
However, the largely steady labour market performance helps ease the downward pressure on the overall economy. In October 2022, unemployment rate in eurozone dropped further to 6.5%, another record low; the unemployment rate in the UK registered at 3.7% from August to October, only a slight rebound from the record low since 1974. The year-on-year (YoY) increase in average weekly wages in the UK, including bonuses, accelerated slightly from 6.0% in July to September to 6.1% in August to October, mainly due to a 0.3 percentage point (ppt) YoY increase in basic wages to 6.1% during the period. Although the European economy is facing multiple uncertainties, a stable employment condition will help alleviate the negative impact of household budget squeeze, supporting consumption and economic activities. In December 2022, the eurozone manufacturing Purchasing Managers Index (PMI) and consumer confidence index stabilized slightly at low levels, rising slightly from November by 0.7 and 1.7 to 47.8 and negative 22.2, respectively. In addition, the UK Manufacturing PMI further fell from 46.5 in November to 45.3 in December, staying below the dividing line of 50 for five consecutive months.

Geopolitical tensions, high inflation, and tightening monetary policy continue to constrain European economic performance.

Inflation eased from record highs, but still exceeds the policy target, prompting further monetary tightening.

In 2023, geopolitics remains the biggest risk for the European economy.

Eurozone & UK GDP Growth



Source: Bloomberg

The 2023 European economic outlook remains full of uncertainties. The geopolitical situation remains the biggest risk, while high inflation, continued tightening of monetary policy, elevated interest rates and fiscal subsidies will add pressure to some member states. It is expected that this will continue to weigh on the overall consumption and investment sentiment. External trade may gradually benefit from the low exchange rates of euro and the British pound, but energy and raw materials imports denominated in US dollar will put pressure on net exports. It is expected that the economic performance of eurozone and the UK in 1H 2023 will not be optimistic. Whether these economies could avoid a recession depends on when the above uncertainties recede.

Inflation retreats from record highs, but central banks are poised to further tighten monetary policy

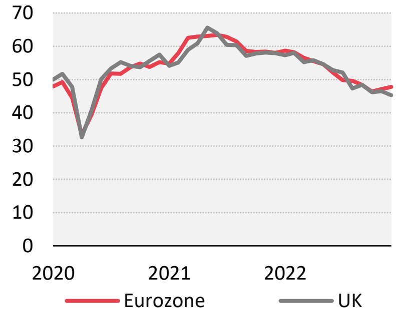
Following record high inflation in eurozone and the UK over the past few months, both have retreated from their highs, but remain well above the central bank's policy target. The central banks are expected to further tighten monetary policy. Following the record high of 10.6% YoY registered in October 2022, the headline inflation rate in eurozone has slowed down for two consecutive months, and its flash estimate in December has dropped further to 9.2% YoY. However, core inflation excluding energy, food, tobacco and alcohol have yet to peak, accelerating from 5.0% YoY in November 2022 to 5.2% in December. After hitting a 41-year high of 11.1% year-on-year in October 2022, the UK inflation rate slightly fell to 10.7% in November. At the same time, the core inflation also remained high, with its YoY increase in November only dropping 0.2 ppt from its peak to 6.3%. Obviously, the inflationary pressure in both eurozone and the UK remain high and far exceed their central bank's policy target. The impact of the pandemic, geopolitics and earlier expansionary policies has yet completely subsided. The central banks are expected to raise interest rates further to control inflation back to their policy targets.

With inflation far exceeding policy targets, central banks are expected to further tighten monetary policy. Since July 2022, the European Central Bank (ECB) has raised interest rates by 250 basis points (bps) in total, of which 50 bps were announced in December, which is slightly slower than the previous two hikes of 75 bps. However, the ECB's President Lagarde said that it is still too early to discuss a policy shift, and further interest rate hikes will still be required for some time to come. In addition to raising interest rates, the ECB also stated that it will start normalizing its balance sheet from March 2023. Starting from Q2 2023, the ECB will reduce the portfolio of the Asset Purchase Programme (APP) by a monthly average of 15 billion euros through non-reinvestment of maturing bonds. Their follow-up actions will need to be further observed. In addition, the Bank of England (BoE) raised the policy rate again by 50 bps to 3.5% at the meeting in December 2022. Since December 2021, the cumulative interest rate increase reached 340 bps. Among the 9 BoE members, 2 supported keeping interest rate unchanged, and 1 supported a rate hike of 75 bps. As the UK inflation remains far beyond the policy target, the BoE is expected to further raise rate until a clear downward trend of inflation is confirmed.

Geopolitics, energy crisis and rapid tightening of monetary policy intensified the turmoil in European financial markets in 2022

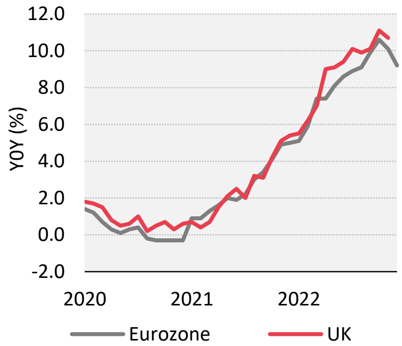
With the US Federal Reserve, the ECB and BoE rapidly raising interest rates in 2022 to curb inflation, geopolitical tensions and energy crisis severely impacting consumer and investment confidence, European financial markets experienced significant volatility in

Manufacturing Purchasing Managers' Index



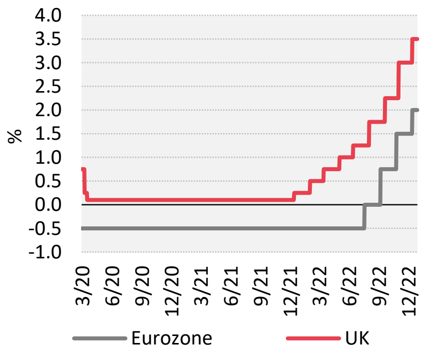
Source: Bloomberg

Eurozone & UK Inflation Rate



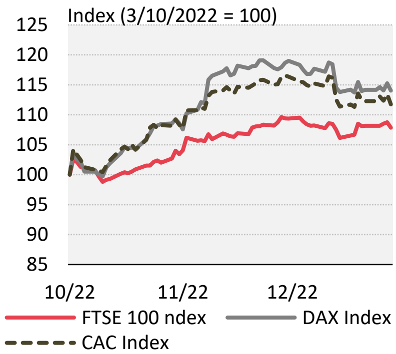
Source: Bloomberg

Policy Rates in Eurozone and UK



Source: Bloomberg

Stock Market Indices



Source: Bloomberg, data as of 30/12/2022

2022. Amid the divergence of monetary policies between the US, eurozone and the UK, the exchange rate of the US dollar continues to strengthen, dragging down the performance of euro and the pound. As of end-December 2022, the euro and pound was trading at USD 1.0705 and USD 1.2083, registering at a depreciation of 5.8% and 10.7% compared to end-2021. After significant fluctuations during the year, the German DAX index, the French CAC index and the British FTSE 100 index fell by 12.3%, 9.5% and increased by 0.9% respectively at the end of 2022, compared with the end of 2021.

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