BEA 東亞銀行

Economic Research

May 2023

Market Monitor – Europe

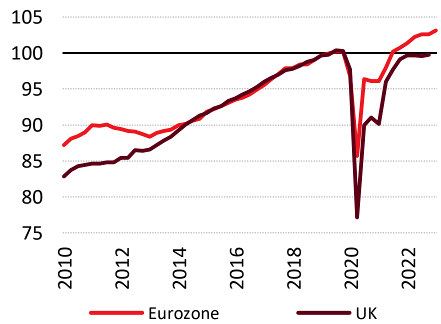
A Mild but Uneven Recovery

- Europe's economy avoided a recession at the beginning of 2023 amid a resilient labour market and recovering external demand.
- Central banks in the eurozone and the UK will maintain monetary policy tightening in the face of still elevated and sticky inflationary pressures.
- Looking ahead, the European economy is expected to mildly expand, led by the recovery of the services sector.

The European economy kick-started a modest recovery

Europe's economy avoided a recession in the first quarter of 2023 after a largely stagnant Q4 2022. Despite multiple headwinds such as high inflation, high interest rates, protests, and strikes, etc., the eurozone economy avoided a technical recession for two consecutive quarters of negative growth in Q1 2023, marginally expanding 0.1% quarter-on-quarter (QoQ) while Q4 growth in EA-19 (Euro Area 19) was nudged down to -0.1% QoQ and EA-20 (Euro Area 20, including Croatia from January 2023) was unrevised at 0.0% QoQ. With the full details yet to be announced, the household spending trend is likely to stay soft in Q1, though it could have been worse without the continued resilience of the labour market. Also, the strength of exports in some countries after the easing of pandemic-related restriction in Mainland China and a buoyant tourism recovery also supported Q1 economic performance.

Real Gross Domestic Product (2019 = 100)



Source: CEIC, BEA Economic Research Department

Germany, the largest economy in the eurozone, avoided a technical recession and stagnated in Q1 2023 after a 0.5% QoQ contraction in Q4 2022, supported by improved capital formation and export performance. Spain's growth accelerated from 0.4% in Q4 2022 to 0.5% QoQ in Q1 2023 and Italy rebounded from a QoQ drop of 0.1% in Q4 2022 to an expansion of 0.5% in Q1 2023. Though clouded by strikes across the country and the cost of living crisis squeeze, the UK economy recorded an average month-on-month growth of 0.2% during January-February 2023 following an upwardly revised 0.1% QoQ expansion in Q4 2022.

With a resilient labour market and resilient consumer sentiment, services spending continued to improve; whilst demand in goods consumption remain hit by elevated inflation. The employment market in eurozone and the UK remain tight, with unemployment rate hovering at around historical low level of 6.5% in March and 3.8% in February, respectively. In April, consumer confidence in the eurozone rose to -17.5 and UK GfK consumer confidence also climbed to -30.0, the highest level since February 2022. Services purchasing managers index (PMI) in the eurozone and the UK also reaching a 12-month high at 56.2 and 55.9 in April, driven by the continuous recovery of travel, leisure, and entertainment. However, retail sales performance was hit by elevated inflation and the shifting of consumption pattern towards services, with average retail sales during January and February 2023 in the eurozone being 0.3% below the average level in Q4 2022. Meanwhile, retail sales in the UK grew modestly by 0.5% QoQ in Q1 2023, partly supported by discount promotions, but remain 3.8% below the same period last year.

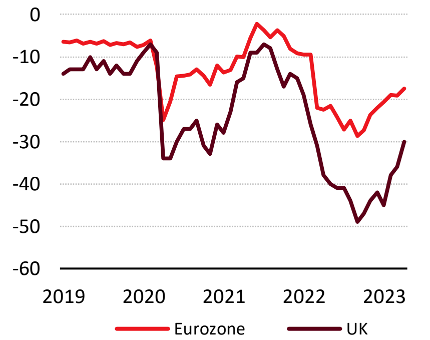
Additional monetary policy tightening in May, but further actions become more data-dependent

Headline inflation has peaked, but its core inflation pressure remains sticky and will take time to return to the central banks' policy target. Eurozone inflation decelerated from the peak of 10.6% in October 2022 to 7.0% in April 2023 while UK inflation fell at a slower-than-expected pace from 11.1% in October last year to 10.1% in March, notably higher than the 9.2% predicted by the Bank of England (BoE) in February. Food and services prices become the key growth drivers for inflation, with energy prices moderating from its high comparison base. In the eurozone, energy inflation eased to 2.5% year-on-year (YoY) in April after recording extended double-digit YoY growth, while food, alcohol and tobacco prices recorded the ninth double-digit growth at 13.6% and services prices accelerated to 5.2% YoY in April respectively. In the UK, food prices accelerated further from 18.0% to 19.1% YoY in March, and its services inflation stayed elevated at 6.6%. Accordingly, eurozone and UK core inflation remained well above the policy target at 5.6% and 6.2% in April and March respectively, signalling sticky inflationary pressure.

The European Central Bank (ECB) raised rate again, but further actions become more data-dependent. The ECB raised its policy rates by 25 basis points (bps) to 3.25% in May 2023 while the BoE is poised to hike interest rate again in May. With the headline and core inflation rates remaining far higher than their policy targets, ECB and BoE are expected to maintain their tight monetary policy stance for an extended period, but their future actions will likely vary. With eurozone's inflation decelerated faster than that of UK, some member states could start exiting their fiscal support measures, and the ECB could see a lower terminal rate when compared to the US or the UK. On the other hand, the double-digit inflation level in the UK and widespread demand for wage hikes could mean the BoE will maintain a tight monetary policy stance for a longer period of time. Nevertheless, their future actions are expected to become more data-dependent ahead.

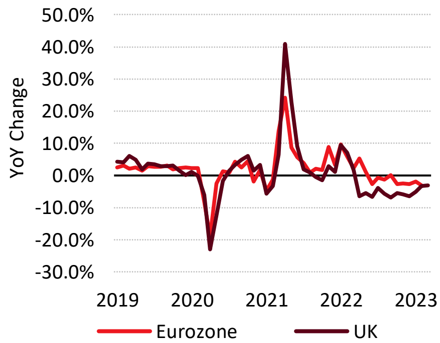
Looking ahead, the European recovery is expected to remain uneven with the services sector taking a lead. The latest PMI data showed an uneven pattern in the past couple of months, with the services PMI continuing to expand and lead that of the manufacturing sector. A resilient labour market, reduced concerns for energy supply, and the elevated inflation reaching its peak are expected to help support consumer confidence. However, the continuous monetary tightening, geopolitical tensions, and the potential

Consumer Confidence Index



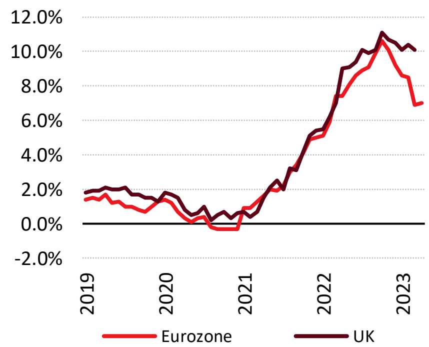
Source: CEIC

Retail Sales



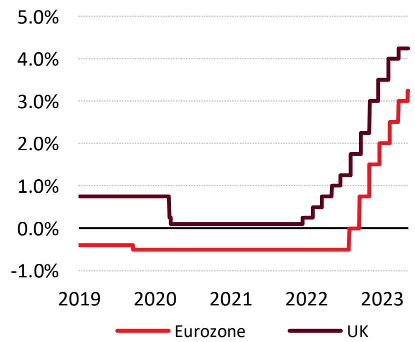
Source: CEIC

Inflation Rate



Source: CEIC

Policy Rate



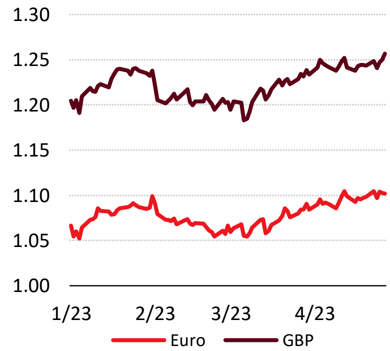
Source: CEIC

repercussions from the banking crisis, etc., are likely to restrain the recovery momentum ahead.

Financial market sentiment turned positive with alleviating worries

Investors' sentiment improved to support a recovery in financial markets. Expectations of the US rate hike cycle to end soon, together with the recent stabilization of investors' sentiment, led to a recovery of financial market sentiment. At end-April, the UK FTSE 100 index, the German DAX index and the French CAC index rose by 3.1%, 1.9% and 2.3%, respectively, compared to end-March. However, expectations of central banks' diverging moves between US, Eurozone and the UK ahead has also supported the Euro and British pound performance. The euro and British pound closed at US$1.1019 and US$1.2567, respectively, representing an appreciation of 1.7% and 1.9% over the same horizon.

Euro & British Pound against USD



Source: Bloomberg, data as of 28/4/2023

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