BEA 東亞銀行

Economic Research

October 2023

Market Monitor – Europe

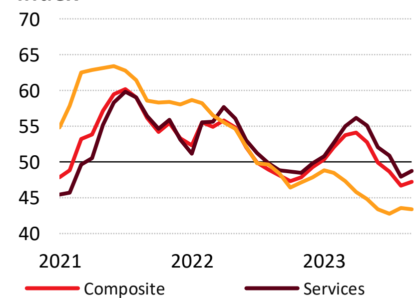
Growth Weakened Further Amid High Interest Rates

- Growth in Europe weakened further as decade-high interest rates increasingly dampened consumer confidence and weighed on business investment.
- The European Central Bank (ECB) and Bank of England (BoE) both indicated that their interest rate levels are sufficiently high but that a restrictive monetary environment will be maintained for a prolonged period.
- The European Commission released its summer forecast, which revised down the eurozone 2023 GDP growth projection to 0.8%, down from 1.1% in the last forecast.

Broad-based weakness seen in across sectors

The growth momentum in the eurozone deteriorates. The eurozone's gross domestic product (GDP) growth for Q2 was revised down from 0.3% quarter-on-quarter (QoQ) to a mere 0.1%, indicating continued stagnation in 1H 2023. The latest purchasing managers' indices (PMI) in the eurozone pointed to a further economic slowdown in Q3, with both the manufacturing and services sectors reporting declines in activity. Due to fading pent-up demand, the services PMI in the eurozone has slipped into contractionary territory for two months in a row (48.7 in September). The manufacturing PMI also showed continued weakness, staying below the 50 expansion/contraction line for 15 consecutive months. Overall, the eurozone's economic outlook remains highly uncertain, amid multiple downside risks such as tight financing conditions, soft external demand, prolonged geopolitical tensions, etc.

Eurozone Purchasing Managers' Index



Source: Bloomberg

While the German economy remained depressed, France experienced a sharper economic slowdown. German industrial production continued to deteriorate in July (-1.6% month-on-month, MoM), dragged down by a 2.9% MoM drop in capital goods. Germany's manufacturing PMI showed no sign of turnaround, hovering below 40 from July to September, suggesting that weak industrial production is likely to persist in Q3. In France, the volume of retail sales entered a downtrend, declining by 0.3% MoM in July and by 2.8% in August. Besides, the services PMI of France decreased sharply from 46 in

August to 44.4 in September, reflecting weak sentiment for the French luxury goods business and services.

Spain is set to be the major driving force supporting the eurozone's growth. The tourism and retail sectors in Spain have grown strongly, driven by buoyant travel demand during the summer holidays. Spain's tourist expenditure surged by 30.6% MoM and 16.4% year-on-year (YoY) to EUR 13.9 billion in July, far higher than the levels seen in the pre-pandemic levels in 2016 - 2019 of around EUR 11.4 billion. Meanwhile, the volume of retail sales in Spain continued to expand, rising by 0.4% MoM in July and August (YoY growth at around 8.0% in July and August).

The UK economy shrank sharply as the impacts of strikes surfaced. The UK's monthly GDP estimate showed a MoM contraction of 0.5% in July, following a 0.5% expansion in June. The contraction was largely due to the widespread industrial actions spanning from health and education to rail workers. Most notably, services output declined by 0.5% MoM in July, being the biggest drag to monthly GDP growth. In addition, production and construction output fell by 0.7% MoM and 0.5% MoM, respectively. It was also the first monthly print since June 2022 that all three major sectors reported MoM contractions.

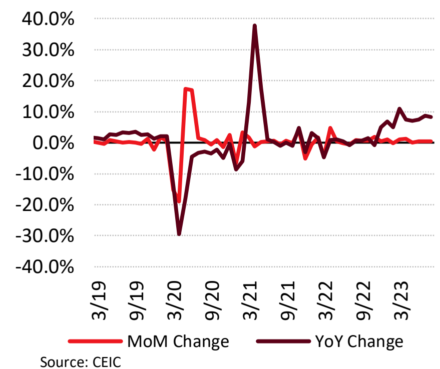
Central banks signalled a pause in rate hikes, but monetary tightening will be maintained for a prolonged period

Inflation in the eurozone decelerated at a faster pace. After a slow moderation from 5.5% to 5.2% YoY during June – August, headline inflation in the eurozone fell remarkably by 0.9 percentage points (pts) to 4.3% in September, the lowest level since October 2021. The decline reflected the high base effect from a year ago as Germany ended fuel discounts and transport subsidies in Aug 2022. Core inflation also slowed from 5.3% YoY to 4.5% in September. It was mainly contributed by softening services inflation, which slowed from 5.5% YoY in August to 4.7% in September. On a MoM basis, services inflation dropped by 0.9% in August, probably led by weak consumer demand.

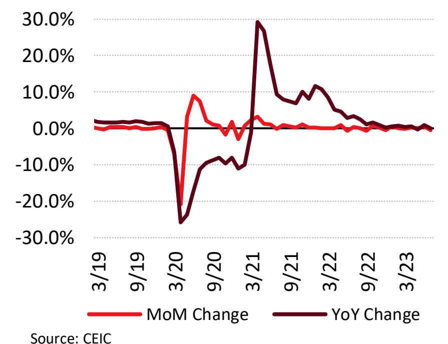
Inflation in the UK also decelerated unexpectedly with a dip in core inflation. Headline inflation in the UK edged down from 6.8% YoY in July to 6.7% in August, lower than the market consensus of a slight rebound to 7.0%. Core inflation also slid to 6.2% YoY in August, 0.9 pts lower than its recent peak of 7.1% in May. The deceleration was mainly caused by slower services inflation, which decreased by 0.6 pts to 6.8% YoY in August after hovering between 7.2-7.4% between May and July. Specifically, the prices for restaurants, hotels and accommodation services retreated during the month.

Rates in Europe are near their peaks. In September, the ECB decided to raise its policy rates by 25 basis points, with the deposit facility rate rising to 4%. Meanwhile, the BoE held its policy rate steady at 5.25% by a narrow margin of 5-4. However, the BoE will expedite the rate of reducing its bond holdings from GBP 80 billion a year to GBP 100 billion a year. Regarding monetary policy outlook, both the ECB and the BOE signalled that current interest rate levels are sufficiently restrictive and that they will take a data-dependent approach with a close assessment on inflation, the economy, and the impacts of monetary policy transmission. Given a worsening growth outlook in Europe, it is expected that the ECB and the BoE will take a pause and maintain their policy rates at current levels to bring down inflationary pressure.

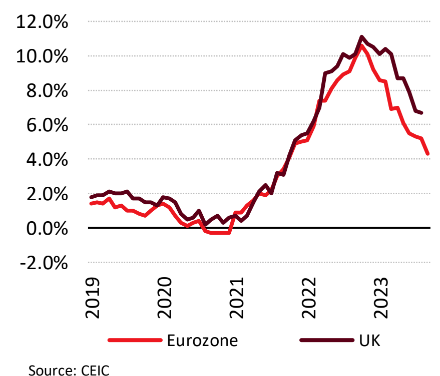
Spain Retail Sales



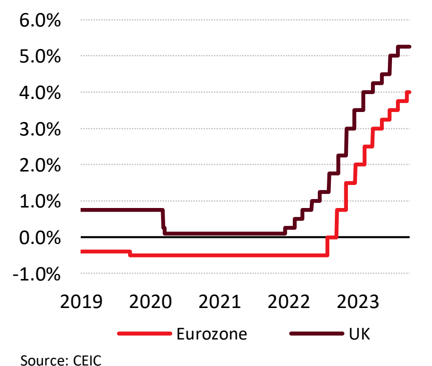
Monthly UK Gross Domestic Product



Inflation Rate



Policy Rate

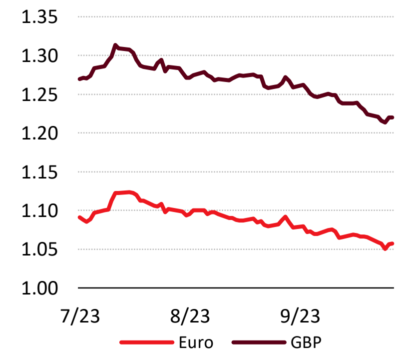


Looking ahead, Europe is set to see continued stagnation. In September, The European Commission released their summer forecast, which revised down the eurozone 2023 GDP growth projection to 0.8%, down from 1.1% in the spring forecast in April. In particular, Germany, the largest economy in the eurozone, is forecast to report an economic contraction of 0.4% in 2023. Apart from rapid monetary tightening from the highest interest rates since 2008 and reduced liquidity conditions, European economies also face downside risks from persistent geopolitical tensions and slowing global demand. It is likely that European economies will continue to underperform their global peers in the near term.

Expectations for higher-for-longer rates weighed on financial markets

Concerns over elevated interest rates dented risk sentiment. Above-consensus economic data in the US and the Fed's hawkish forward guidance sent the US treasury yields soaring, delivering an additional boost to the strength of the US dollar and dragging market sentiment. Meanwhile, higher yields added pressure to the valuation of risky assets and weakened the currency's performance in Europe. Rising oil prices also raised fears of further monetary tightening due to a potential reacceleration of inflation, although some stock indices in the region actually benefited from the rise of energy-related sectors. At the end of September, the equity markets in Europe showed mixed performance. The UK FTSE 100 index increased by 2.3%, while the German DAX index and the French CAC index declined by 3.5% and 2.5%, respectively, when compared to end-August. The euro and British pound closed at US$ 1.0573 and US$ 1.2199 in September, respectively, representing a depreciation of 2.5% and 3.7% over the previous month.

Euro & British Pound against USD



Source: Bloomberg, data as of 30/9/2023

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