Economic Research

November 2023

Market Monitor – Europe

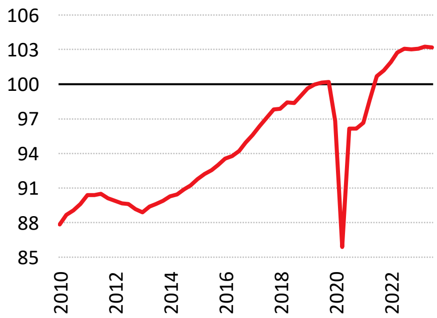
Weakening Prospects amid Multiple Headwinds

- The Eurozone's GDP contracted in Q3, reflecting subdued foreign demand, tighter financing conditions, and a fading boost from reopening; the UK's growth momentum stayed muted with softening sentiment.
- The Eurozone's headline inflation fell, while the UK's inflationary pressure was still sticky.
- The ECB and BoE held their policy rates unchanged, with both approaching the end of their rate hike cycles.

Growth momentum remained largely stagnant

The eurozone economy remained weak amid multiple headwinds. Given subdued foreign demand, tighter financing conditions, and a diminishing boost from reopening, the eurozone witnessed a weakening trend across manufacturing and services sectors. In Q3 2023, gross domestic product (GDP) in the eurozone contracted by 0.1% quarter-on-quarter (QoQ), with the year-on-year (YoY) growth slowing from 0.5% in Q2 2023 to 0.1% in Q3 2023. While the QoQ decline of eurozone GDP in Q3 2023 was largely due to a 1.8% QoQ contraction in Ireland, a broad-based slowdown was seen among major eurozone member states. Particularly, Germany, the biggest eurozone economy, contracted by 0.1% QoQ in Q3, down from a growth of 0.1% in Q2.

Eurozone Real Gross Domestic Product (2019 = 100)



Source: CEIC, BEA Economic Research Department

Service-oriented economies such as France and Spain also moderated. GDP growth in France and Spain slowed to 0.1% and 0.3% QoQ in Q3, down from 0.6% and 0.4% in Q2, respectively. Economic growth in both economies was mainly supported by resilient household final consumption (France: up 0.7% QoQ in Q3; Spain: up 1.4% QoQ). In the meantime, Italy avoided a technical recession with 0.0% QoQ GDP growth in Q3, up from a 0.4% contraction in Q2. According to Italy's national statistics bureau, the flat GDP reading in Q3 was attributed to a decrease in domestic demand, offsetting the positive contribution from net exports.

The UK's underlying growth momentum stayed subdued. The UK's monthly GDP estimate grew slightly by 0.2% month-on-month (MoM) in August, following a 0.6% fall in July due to strikes. The services sector expanded by 0.4% MoM, serving as the main contributor to monthly growth, while the production and construction sectors continued to contract for the second consecutive month, down by 0.7% and 0.5% MoM in August. Given that the decline in July was larger than its rebound in August, the possibility for the UK economy to slip into a contraction in Q3 2023 remained high. Furthermore, there were renewed strikes taking place in October, posing risks to the economic performance in Q4.

European labour markets started to show signs of cooling. The eurozone unemployment rate increased from 6.4% in August to 6.5% in September, with the number of unemployed people rising by 69,000. In the UK, the estimate of payroll employees marked the third monthly decline in September, down by 11,000 from August. Meanwhile, the number of vacancies in the UK decreased further to 988,000 in Q3, the lowest level since May - July 2021. These reflected a moderating labour demand. But wage pressure in the UK stayed high, with regular pay (excluding bonuses) rising 7.8% YoY in June – August.

Central banks signal rates near their peaks

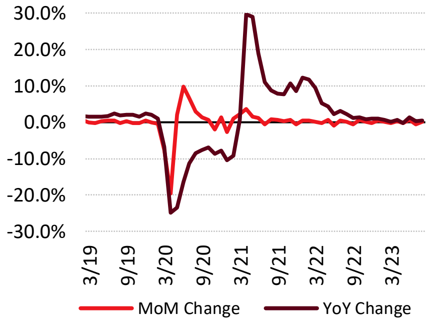
The Eurozone's headline inflation fell due to high base effects in energy prices. The eurozone headline inflation decelerated remarkably from 4.3% in September to 2.9% YoY in October, as the high base of comparison in 2022 led to a widened YoY decline in energy prices at 11.1% in October, up from a drop of 4.6% in September. In the meantime, core inflation eased slightly to 4.2% YoY in October, down from 4.5% in September. Services inflation moderated slightly from 4.7% in September to 4.6% YoY in October. Given the stalled economic growth and the recent moderation in the labour market, wage pressure in the eurozone is likely to soften, which will help tame inflationary pressure ahead.

The UK's inflationary pressure was still sticky. The UK's headline CPI inflation remained unchanged at 6.7% YoY in September, with the core CPI inflation edging down from 6.2% in August to 6.1% YoY in September. Compared to other advanced economies, the UK's inflationary pressure remained relatively high. Particularly, services inflation was still elevated at 6.9% YoY in September, highlighting the persistence of underlying inflationary pressure, which was probably driven by higher wage growth in the UK. As such, a further slowdown in the UK's labour market is needed to durably bring down inflation.

Central banks in Europe and UK held rates unchanged, signalling an end to further hikes. Both the European Central Bank (ECB) and the Bank of England (BoE) decided to keep their policy rates unchanged after their meetings on 26th October and 2nd November, respectively. The ECB's deposit facility rate and the BoE's bank rate stayed at 4.0% and 5.25%, respectively, representing an increase of 450 and 515 basis points in this global rate hike cycle. Despite stagnating economic growth in the region, inflation has persistently exceeded the central banks' targets, reaching levels that have been far too high for too long, especially in the UK. Hence, the ECB and BoE are likely to hold rates at elevated levels for a while, even though further slowdowns in their labour markets emerge.

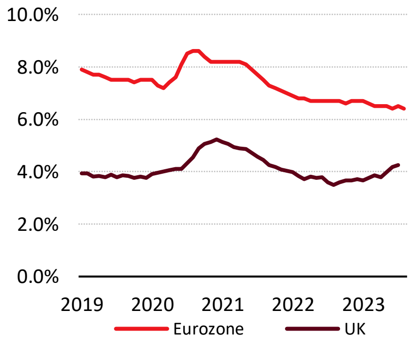
Looking ahead, the economic outlook in Europe is likely to deteriorate. Leading indicators pointed to further downward pressure. The Eurozone composite purchasing managers' index (PMI) declined to 46.5 in October. For the UK economy, the GfK

Monthly UK Gross Domestic Product



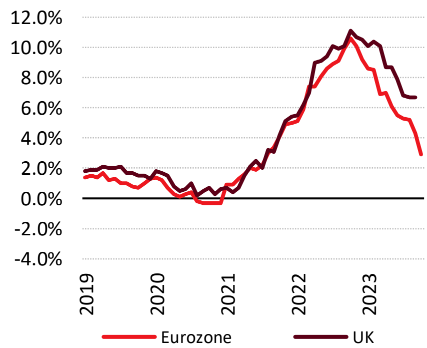
Source: CEIC

Unemployment Rate



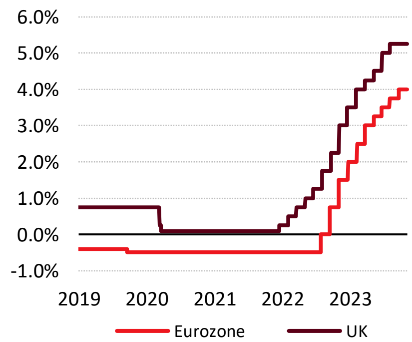
Source: CEIC

Inflation Rate



Source: CEIC

Policy Rate



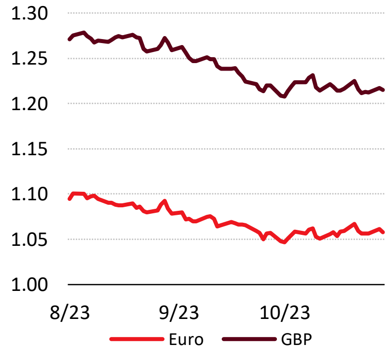
Source: CEIC

consumer confidence index sharply dropped from -21 to -30 in October. And the UK manufacturing PMI remained weak at 44.8 in October. Together, these indicated a largely stagnant, if not mildly contracting, momentum in Europe at the start of Q4.

Financial market sentiment stayed fragile

Investors stayed on the side lines in the face of multiple uncertainties. In the global financial markets, the conflict between Israel and Hamas increased risk-averse sentiment, boosting demand for safe-haven assets. Moreover, the softer-than-expected eurozone economic readings also weakened market confidence in the region's economic outlook. At the end of October, the UK FTSE 100 index, the German DAX index and the French CAC index declined by 3.8%, 3.7% and 3.5%, respectively, when compared to end-September. The euro held largely steady at US$ 1.0575 over the previous month, while the British pound depreciated slightly by 0.4% to US$ 1.2153 in October.

Euro & British Pound against USD



Source: Bloomberg, data as of 31/10/2023

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