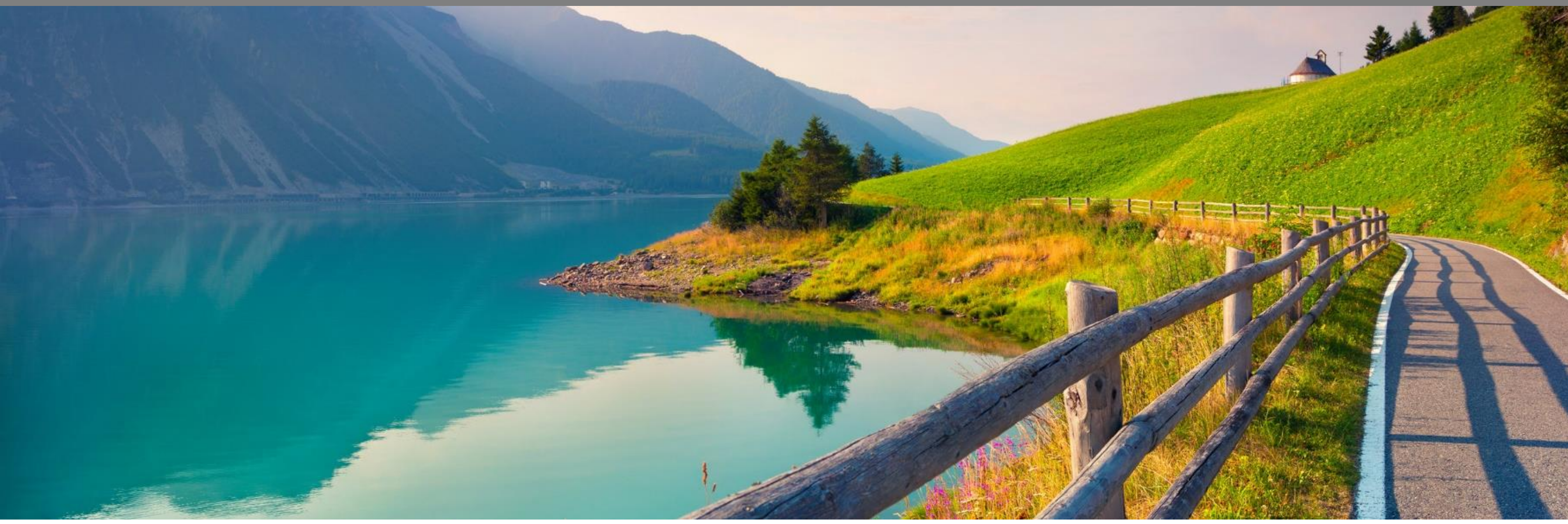
BEA 東亞銀行

Economic Research **February 2024**

Market Monitor – Europe

Muted Momentum with Central Banks Turning Slightly Dovish

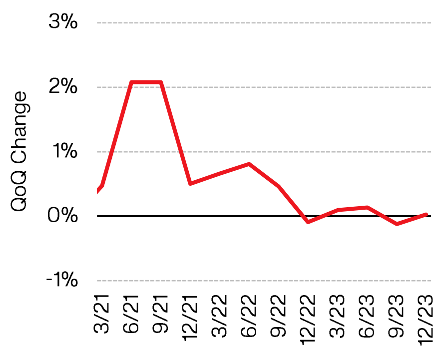


- The eurozone economy stagnated in Q4 2023, with Germany being the drag and Spain posting robust growth. UK's economy showed a turnaround in monthly GDP in November 2023.
- Headline inflation edged down further, but service inflation stayed relatively high and remained sticky.
- The ECB and the BoE kept their policy rates unchanged, with their guidance turning slightly dovish but yet to signal the timing of rate cuts.

Eurozone economic momentum remained muted

The eurozone economy stagnated in Q4 2023. In the face of the fading boost brought about by normalised fiscal spending, elevated interest rates, weakened foreign demand and escalated geopolitical tensions, the eurozone economic recovery has remained subdued since 2H 2023. In Q4 2023, the eurozone real gross domestic product (GDP) stagnated at 0.0% growth quarter-on-quarter (QoQ), after a slight decline of 0.1% in Q3 2023. No details were released with the flash estimate, but early information at the country level hints at weak domestic demand, particularly investment, in Q4 2023. For the whole year of 2023, the eurozone economy grew modestly by 0.5%, down sharply from a 3.4% growth in 2022.

Eurozone Economic Growth



Source: CEIC

Major eurozone economies showed a divergence in growth. A contraction in Germany and stalled momentum in France offset a pick-up in growth in Spain and Italy. In Q4 2023, Germany served as the main drag, with its economy shrinking by 0.3% QoQ, and France's economy posted flat growth. In the meantime, Spain's and Italy's economies grew by 0.6% QoQ and 0.2%, respectively. For 2023 as a whole, Spain's economy grew strongly by 2.5%, followed by France (0.9%) and Italy (0.7%), while Germany's economy contracted by 0.3%.

Survey indicators pointed to sentiment stabilising at low levels. The HCOB eurozone composite purchasing managers' index (PMI) improved slightly to 47.9 in January 2024, up from 47.6 in December 2023, indicating that private sector enterprises are less pessimistic now than in the past few months and pointing to a largely stagnant condition. However, there were reports of lengthened delivery times and higher shipping costs due to the disruption in the Red Sea, which unearthed the vulnerability of the Eurozone and its exposure to geopolitical tensions as well as the upside risk to inflation.

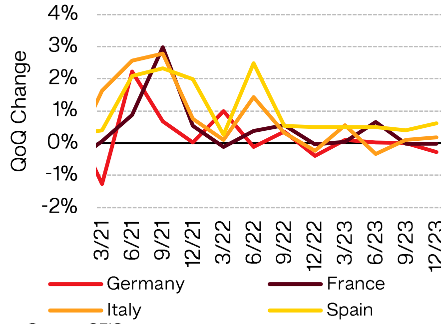
Resilient labour market conditions are likely to support a stabilizing outlook. While the eurozone economic momentum stayed slow throughout 2023, the eurozone labour market proved resilient. In December 2023, the eurozone's unemployment rate maintained a historical low of 6.4%, down from 6.7% in December 2022. Furthermore, workers in the region enjoyed a faster pay rise in 2023, with the eurozone year-on-year (YoY) wage growth hitting 5.0% in Q1 2023, 4.6% in Q2 2023 and 5.3% in Q3 2023. Along with moderating inflation, higher wages are poised to boost consumption, which will provide crucial support for a mild economic recovery in 2024.

The UK economy resumed growth in November 2023. The monthly estimate for the UK's GDP rebounded by 0.3% month-on-month (MoM) in November 2023, following a 0.3% drop in October 2023. During the month, the services sector was the main driver of the turnaround, with a 0.4% MoM growth, and the production sector edged up by 0.3%, while the construction sector shrank for the second consecutive month by 0.2%. Overall, the UK's economic growth in Q4 2023 likely stayed flat after a 0.1% contraction in Q3 2023. Meanwhile, business sentiment showed an improving trend. The UK composite PMI increased to 52.9 in January 2024, marking the third straight month of an accelerating pace of expansion. Rising optimism was mainly driven by the services sector, with a rebound in output, orders and employment. It suggests that the UK economy should see a pickup in recovery momentum in early 2024.

Inflation eased with sticky services price pressure

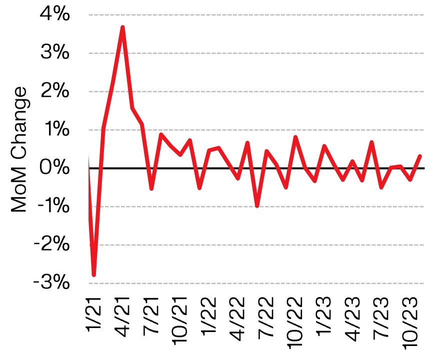
Inflation in the eurozone eased slightly. In January 2024, the eurozone's headline and core CPI inflation inched down by 0.1 percentage point (ppt) to 2.8% and 3.3% YoY, with their MoM declines at 0.4% and 0.9%, respectively. The slowdown in inflation was led by energy (-6.3% YoY) and core goods (2.0%). Price gains for services in the eurozone moderated more slowly than expected, staying stable at 4.0% YoY growth for three consecutive months. This likely reflected the lingering price pressure from high wage growth. While high-frequency wage indicators showed that wage growth should begin to come down in early 2024, it remained uncertain regarding the path of services inflation, particularly because some sectors demand high levels of pay rises in their wage negotiations. Moreover, the declines in energy prices should gradually narrow as favourable base effects fade and national governments exit their energy-related alleviation measures. Further easing in services inflation will be needed to bring inflation back to the 2% policy target.

Economic Growth of Selected Eurozone Member States



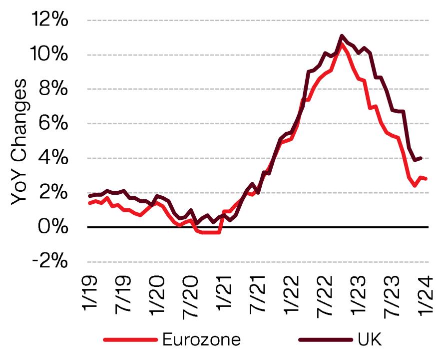
Source: CEIC

Monthly UK Gross Domestic Product



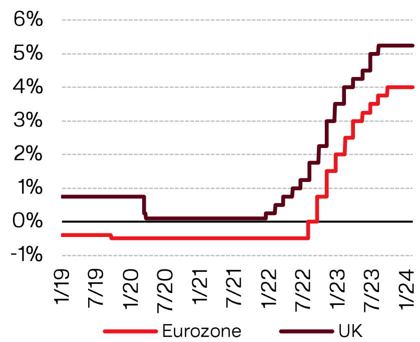
Source: CEIC

Inflation Rate



Source: CEIC

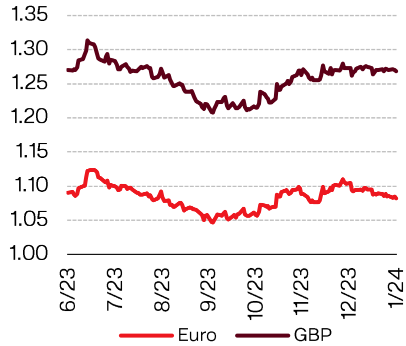
Policy Rate



Source: CEIC

The UK's inflation unexpectedly accelerated in December 2023. Headline inflation in the UK edged up from 3.9% YoY in November to 4.0% in December 2023, while the core CPI stayed unchanged at 5.1%. On a MoM basis, the headline and core CPI rose by 0.4% and 0.6%, respectively. While the rise in headline CPI in December was primarily driven by higher alcohol and tobacco prices given the increase in tobacco duty, services inflation remained a major driver for inflation at 6.4% YoY, up from 6.3% in the preceding month. During September - November 2023, the growth of average weekly earnings (excluding bonuses) softened to a still elevated 6.6% YoY. This indicates that it would still exert pressure on services inflation in the future.

Euro & British Pound against USD



Source: Bloomberg, data as of 31/1/2024

The central banks in Europe sounded positive about the disinflation progress but remained ambiguous about the timing of rate cuts. The European Central Bank (ECB) and the Bank of England (BoE) held their policy rates unchanged at their latest monetary policy meeting. For the ECB, its post-meeting statement took a slightly dovish tone by confirming that "*the declining trend in underlying inflation has continued*", a shift from *"inflation likely to pick up again temporarily in the near term"* in its previous meeting. For the BoE, inflation projections were updated, which showed CPI inflation would temporarily fall to 2.0% YoY in Q2 2024, with a small uptick to 2.2% in Q3 and 2.7% in Q4 2024. The February projections were significantly lower than the projections made in November 2023. Also, the BoE stated that it will keep reviewing how long the policy rate should be maintained at its current level, a change from the warning for further tightening in the previous meetings. Overall, we expect that the ECB is likely to cut its policy rates in mid-2024, while the BoE is likely to start easing at a later stage given the higher underlying inflation pressure in the UK.

Financial markets were mixed, and European currencies retreated

Market sentiment cooled as a result of easing expectations. The better-than-expected US economic performance and the Fed's guidance for ruling out the widely anticipated rate cut in March 2024 led to a market repricing for the US easing trajectory, giving a boost to the US dollar and sending government bond yields to surge. Meanwhile, certain sectors, such as technology, reported strong positive financial results, fuelling a rally in some equity markets. At the end of January 2024, equity markets' performances in Europe were mixed. The UK FTSE 100 index declined by 1.3%, while the German DAX index and the French CAC index rose by 0.9% and 1.5%, respectively, compared to end-December 2023. The euro and British pound closed at US$ 1.0818 and US$ 1.2688 in January 2024, respectively, representing a depreciation of 2.0% and 0.3% over the previous month.

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