Holding fire

The Eurozone is an open economy with a trade-to-GDP ratio (exports + imports as a share of GDP) of 85% - well above that seen in the UK, Japan and the US (see Chart 6). This high trade intensity makes the region more sensitive to the global trade cycle, which has weakened markedly. Indeed, international export volumes have fallen 3.1% in annualised terms over the first half of the year, even before the recent market volatility. The weakness in global trade is largely a reflection of a slowdown across many emerging market economies. Eurozone exposure to these regions is not insignificant. Exports to China (including Hong-Kong to account for re-exporting) amount to 8% of the total. When we add the rest of the BRIC economies this share doubles to 16%, while the exposure to other Eastern European economies such as Turkey (3.3%) is also relatively high. Slowing activity rates in these economies provide headwinds for Eurozone exporters, partly negating the boost from a weaker euro. However, all is not lost. Developed markets account for a clear majority of Eurozone exports, with the UK and US alone taking around a quarter. Furthermore, integrated supply chains mean that the final demand for exports to emerging markets comes in part from the developed world. **Overall, the European Central Bank (ECB) is likely to adjust, rather than slash, its export forecasts.**

The good news is that the Eurozone recovery has been chugging along solidly, even in the wake of weak global trade. Indeed, domestic demand has driven the recent upturn, with the contribution from net trade broadly neutral (see Chart 7). There was further evidence of strengthening cyclical momentum in Europe last week. Monetary data showed an encouraging acceleration in M3 growth to 5.3% year-on-year (y/y) in July, supported by increased lending flows to both non-financial corporations (0.9% y/y) and households (1.9% y/y). This domestic demand story will receive an additional boost from the further leg down in commodity prices. **Eurozone consumers were quick to spend the windfall from last year's drop; this provides an unambiguous stimulus to a region with low exposures to commodity production.** The one concern is that the turbulence in financial markets at home and abroad in August might weigh on the recovery. Survey data over August has surprised to the upside thus far, providing cause for cautious optimism. However, we will need to watch the data closely in coming months to track the extent of the slowdown in emerging economies and its feedthrough to Eurozone activity, both through exports and domestic activity.

The drop in commodity prices will cause some nervousness at the ECB. Indeed, there is a good chance that the central bank will revise its headline inflation profile lower this year and next. **While this will raise eyebrows, we do not think it will elicit a policy response.** As noted, there are few signs as yet that the market turbulence over the summer will have a material impact on the Eurozone recovery. Indeed, the Central Bank is likely to prefer to wait and see how quickly markets stabilise and the degree of damage inflicted by the episode. President Draghi will be keen to strike a dovish tone and should emphasise the willingness of the ECB to take further action if the Eurozone outlook were to deteriorate. However, it would be a surprise to see any pre-emptive strike at this current juncture.

Chart 6: Eurozone open for business

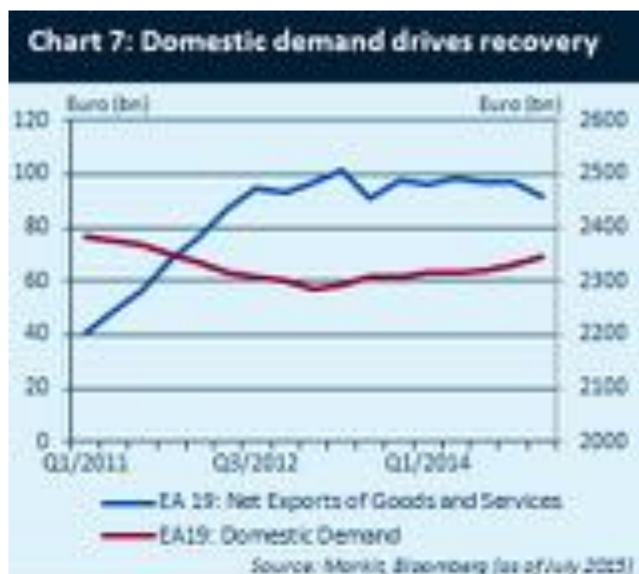

Chart 7: Domestic demand drives recovery

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