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Effects of strong euro emerge even as economy remains stable

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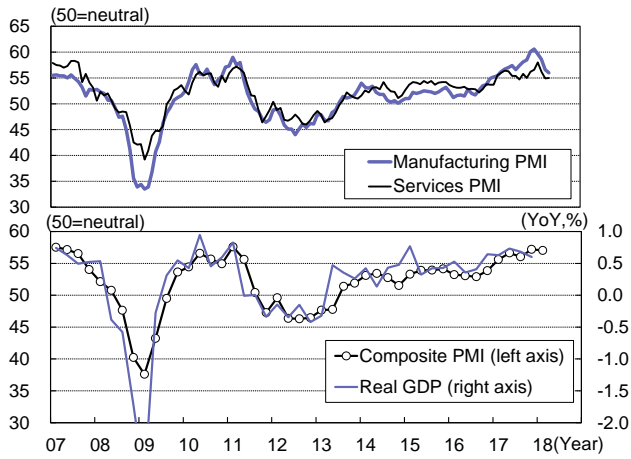
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The Eurozone economy has as a whole remained stable this year. The quarterly average for Q1 composite purchasing managers index (PMI), a measure which points to the overall direction of the economy, was at a 7-year high, meaning that we can expect to see stable real GDP growth for the same period when the data is published on 2nd May (chart 1). However, looking at individual indices, there are signs that the influence of the euro, which has appreciated at a relatively quick pace, is beginning to appear in other areas, particularly manufacturing. April marked the fourth consecutive month of decline in Eurozone manufacturing PMI. In terms of individual components, new export orders have seen 5 months of decline, notably hitting a low last seen in October 2016, and there is a clear loss of momentum into Q2. In terms of other economic indicators, the European Commission's industrial confidence indicator declined for a second consecutive month in March, and month on month (MoM) industrial production has been negative for 3 consecutive months. The pace of expansion of nominal exports to countries outside the Eurozone is also weakening. Data for February and March indicates factors such as temporary slowing of the flow of goods due to a cold snap, but it is hard to deny that the data shows momentum in industry is slowing.

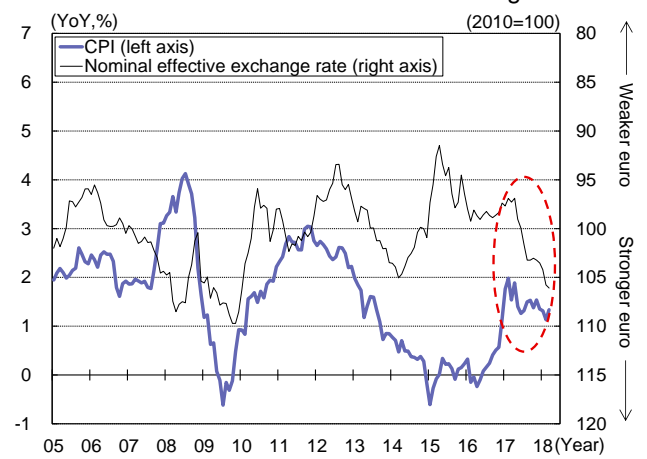
The appreciation of the euro is also exerting an influence over monetary policy. Though the rate of Eurozone consumer price inflation (CPI) for March rose further than the previous month to 1.3% year on year (YoY), it has been gradually slowing over the last year or so as the euro has appreciated. Convergence with the ECB inflation target (just under 2% YoY) does not appear to be on the horizon in the short term (chart 2). The ECB is increasingly cautious over the strength of the euro, stating that "developments in foreign exchange markets continued to be a significant source of uncertainty and a risk that needed monitoring". Originally, euro appreciation came against a backdrop of heightened expectations of tightening monetary policy. It is also true that the ECB has a dilemma whereby attempts to advance monetary policy normalisation beckon a stronger euro, which in turn becomes a factor slowing down monetary policy normalisation. It is likely the ECB will carry out policy normalization with caution, taking into consideration the significant impact of suggestions about a starting period for rate hikes on financial markets.

Chart 1: Eurozone PMI and Real GDP



Source: Eurostat, IHS Markit, MUFG Bank Economic Research Office

Chart 2: Eurozone CPI and Euro Exchange Rate



Source: Eurostat, BIS data, MUFG Bank Economic Research Office

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