THE ECB IS STAYING THE COURSE

Even though euro area inflation likely peaked last October, the disinflation process is expected to be slow, with inflation not expected to fall back to its 2% target level before 2025. The most recent macroeconomic projections from the European Central Bank (ECB) all point to this direction of travel. The second wave of inflation is significant, with the HICP excluding energy climbing by 7.9% y/y in March, while further food-price increases are expected for the months ahead. Despite this, economic activity within the Monetary Union is holding up better than expected against the double shock of inflation and interest rate hikes. While a recession is currently being ruled out for 2023, growth is still incredibly fragile. Unemployment remains at record lows, fuelling labour shortages and faster wage increases.

Negotiated wages (collective bargaining agreements) in the euro area have gone up over the past year, with a 2.9% year-on-year increase recorded during Q4 2022. Labour costs, which include expenses on top of gross salaries (employer social security contributions, training and recruitment costs, bonuses), increased more rapidly, with a 5.7% y/y rise recorded during Q4 2022.

Varying levels of tightness were felt on the labour markets from country to country, but recruitment shortages remained high across the euro area, at a time when the unemployment rate has been at its lowest levels since the Monetary Union was created, standing at 6.7% in February. The European Commission's quarterly survey has identified labour and equipment shortages as the main drags on business activity. However, as highlighted in the same survey, tighter financial conditions and slower demand are growing barriers that are expected to worsen over the course of the year.

At its meeting on 16 March, the ECB hiked the interest rate on its deposit facility by 50 basis points to 3.0% (the interest rate on the ECB's main refinancing operations was raised to 3.5%). However, we do expect further hikes, with the deposit facility rate peaking at 3.5% (and the refinancing rate peaking at 4.0%) in June. In its most recent macroeconomic projections (March 2023), the ECB revised its inflation forecast for the next three years (2023-2025) downwards, citing the larger than expected fall in energy prices as a determining factor. However, it revised its inflation forecast excluding energy for 2023 upwards from 5.3% to 5.8%. This significant adjustment implicitly reflects the lack of a clear picture around short-term trends in food prices. National governments across the board are still struggling to keep these prices in check, despite packages of measures being gradually rolled out (such as the «anti-inflation quarter» in France and the temporary abolition of VAT in Spain).

Business growth is still incredibly uncertain, and a contraction during Q1 2023 could yet occur. However, survey data improved over the quarter, suggesting that if there is a contraction, it will be small. The Composite PMI, which had been in contractionary territory since July 2022, rose back above this threshold at the beginning of the year (54.1 in March), driven by rises in the services sector (55.6), while activity in the manufacturing sector has continued on its downwards spiral (47.1). Despite the Chinese economy reopening and bottlenecks on global production chains easing, there still has not been a subsequent flurry of activity among European manufacturers. These manufacturers have been suffering as a result of stubbornly sluggish domestic consumption, which has been slowed by the drop in household purchasing power. In volume terms, euro area private consumption (national accounts) even fell during Q4 2022 (-0.9% q/q), remaining at around 1% below its pre-Covid level.

GROWTH & INFLATION

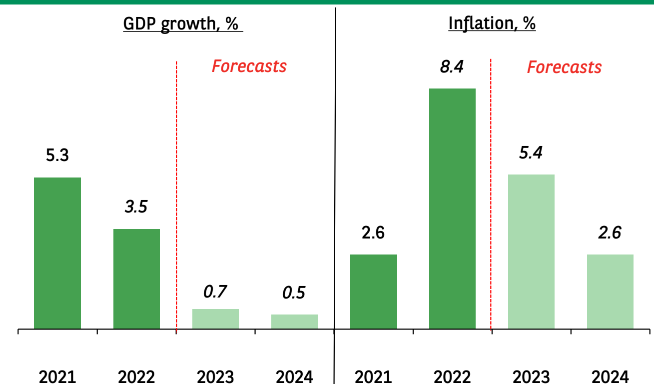

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

THE RELAUNCH OF THE EUROPEAN FISCAL COMPACT

Looking beyond the short-term concerns about the effects of monetary tightening, the European Commission plans to reactivate the Stability and Growth Pact rules in 2024, which had been frozen at the height of the Covid-19 pandemic and were once again suspended as a result of the war in Ukraine and the energy shock. The two main convergence criteria limit government deficits in euro area countries to 3% of GDP and debt in Member States to 60% of GDP. However, this framework will be relaxed so that it is better suited to the new economic environment, and in particular to government debt within the euro area, which is almost 25 GDP points higher than it was prior to the 2008 financial crisis. Member States will also need significant levels of investment to support their green and digital transitions, while seeking further financing in order to strengthen their energy and defence sectors. On 14 March, the Finance Ministers of the Eurogroup agreed on the broad outlines of this new European compact, which will still need to be refined and approved by the Heads of State. An agreement could be reached during the spring.

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