

## EUROZONE: THE IMPORTANCE OF LEVELS AND CHANGES IN LEVELS

The analysis of the cyclical environment tends to focus on the change in the level of economic variables (growth, inflation), rather than on the level (activity, prices) itself. However, both matter. The recent decline in energy price inflation is good news but the price level remains well above that recorded at the start of last year. In the manufacturing and construction sectors, the assured production based on the level of order books remains very high. This might explain what hiring plans remain elevated. However, the order intake has been slowing. Historically, such a development has been followed by a reduction in the length of the assured production. Focusing too much on the high level of the latter today entails the risk of overestimating the strength of the manufacturing and construction sector.

In the analysis of the cyclical environment, growth and inflation tend to play a central role. This shouldn't come as a surprise. After all, a prolonged period of sustained growth raises the likelihood of a pickup in inflation. The latter in turn is relevant for central banks and the level of interest rates. Growth and inflation represent the change of a variable over a given time period -monthly, quarterly, annual- but this focus on, in mathematical terms, first differences, should not make us forget that at times, the level of activity, demand, prices, etc. also play an important role. For instance, a rebound in equity prices -the first difference is positive- may represent little in terms of support to household confidence when the stock market is still well below its recent highs. But, on the contrary, a big decline in asset prices may complicate the access to credit because the collateral is less valuable. A drop in property prices may put homeowners in a situation of negative equity, whereby the value of their house is lower than that of their mortgage. This may weigh on their spending and restrict their geographical mobility due to a reluctance to crystallise their loss.

Another significant example is what is happening to inflation today. The decline in energy prices in recent months is reflected in a huge drop in annual energy price inflation, which in turn has contributed to lower headline inflation. However, chart 1 shows that the energy price component of the Eurozone HICP is still well above its level reached at the start of 2022 or earlier: its recent fall has not erased much of its preceding sharp rise. This means that the shock to household budgets and the costs of businesses continues to make itself felt -although less than before thanks to the recent price decline- and this may prop up wage demands and influence price setting behaviour of companies as well as negatively impact consumer and corporate spending. Such a backward looking behaviour may lead to inflation inertia and slow down the pace of disinflation.

<sup>1</sup> Data are from the European Commission's business surveys. The question for manufacturing is formulated as follows: "Do you consider your current overall order books to be...? + more than sufficient (above normal) = sufficient (normal for the season) - not sufficient (below normal)." Source: European Commission, The Joint Harmonised EU Programme of Business and Consumer Surveys, User Guide, January 2023 update.

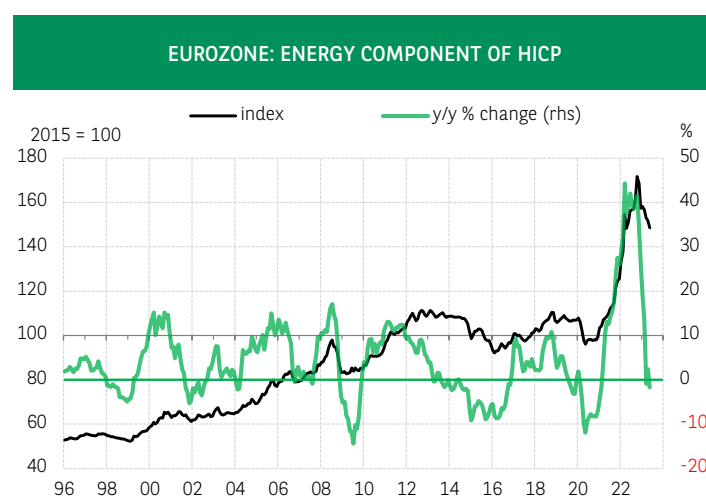


CHART 1

SOURCE: EUROSTAT, BNP PARIBAS

When analysing activity and demand, levels also matter. Charts 2 and 3 show the assessment of the order books by Eurozone companies in the manufacturing and the construction sector<sup>1</sup>. In both cases, a significant decline can be noted since the start of 2022.

However, in manufacturing, the duration of production assured by current order books remains close to its historical record and in construction, the current backlog in orders corresponds to an ensured operating time in months that is also close to record levels.

Historically, a deterioration of the order book assessment -a slowing order intake- has been followed by a reduction in the length of the assured production. Focusing too much on the high level of the latter today entails the risk of overestimating the strength of the manufacturing and construction sector.



# EDITORIAL

In the terminology used before, these variables can be considered as representing the level of the order book -the total of orders received in the past and which have not yet been executed-, whereas the assessment of order books focuses on new orders and hence is correlated with the change in the order book level (charts 4 and 5).

Historically, a deterioration of the order book assessment -a slowing order intake- has been followed by a reduction in the length of the assured production. This implies that focusing on the high level of the latter today entails the risk of overestimating the strength of the manufacturing and construction sector: weakness in these sectors is building as new orders are diminishing.

The good news is that, as long as the length of assured production remains high, companies may be inclined to keep on hiring staff. The bad news is that it may also create a feeling that pricing power is still high.

**William De Vijlder**

## EUROZONE: BUSINESS SURVEYS, TOTAL MANUFACTURING

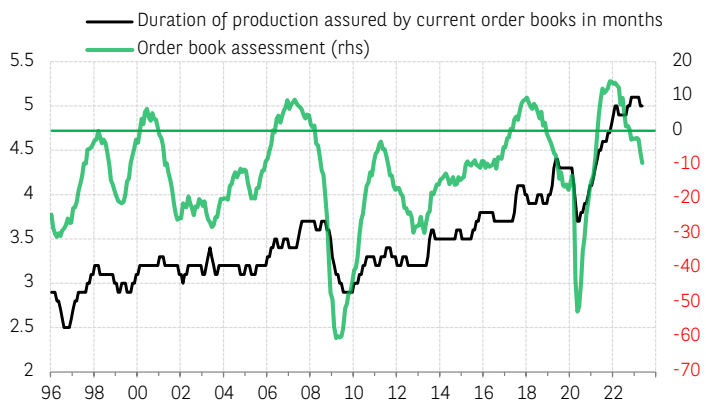


CHART 2 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

## EUROZONE: CONSTRUCTION SURVEYS

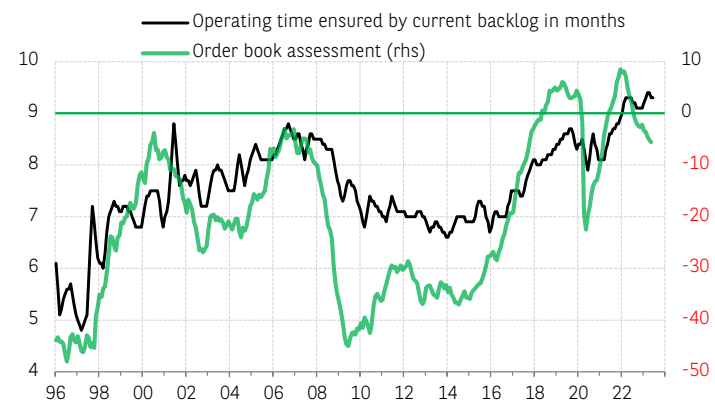


CHART 3 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

## EUROZONE: BUSINESS SURVEYS, TOTAL MANUFACTURING

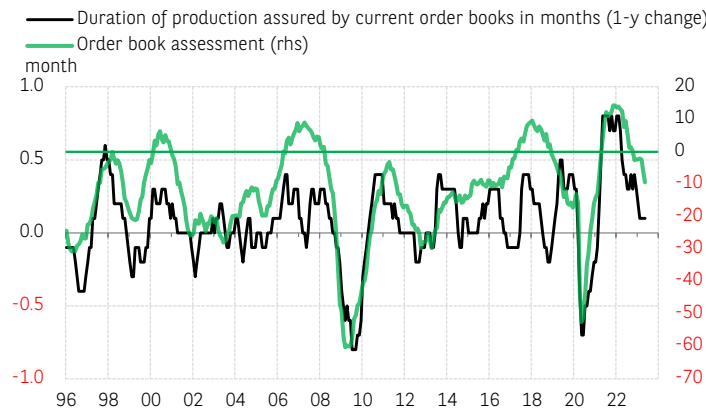


CHART 4 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

## EUROZONE: CONSTRUCTION SURVEYS

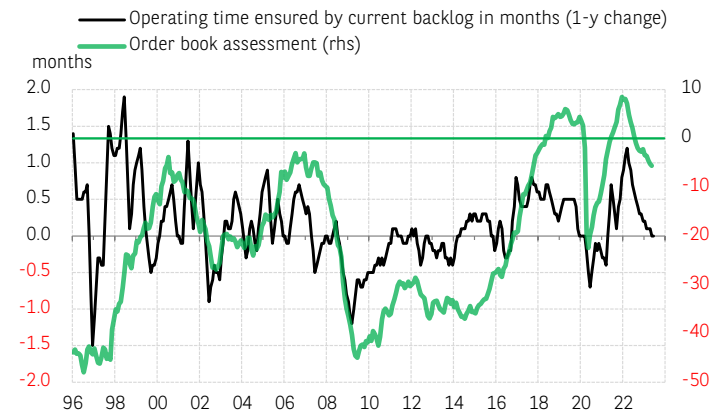


CHART 5 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS