EUROZONE

INFLATION FALLS, THE ECB MANAGES EXPECTATIONS

Eurozone activity is expected to pick up moderately in 2024, buoyed by the fall in inflation and the start of a cutting cycle of policy rates, which, according to our forecasts, will take place in April. The labour market continues to surprise on the upside. However, industrial production is falling sharply and remains highly exposed to escalating tensions in the Red Sea and the repercussions on shipping and supply chains. 2024 will see a number of national parliamentary and presidential elections (Finland, Portugal, Belgium, Austria) and the European elections (6 to 9 June), which are likely to redraw the political landscape in the region and the balance of power within the European Parliament.

Growth and employment in the Eurozone held up well overall against the interest rate shock in 2023. In 2024, GDP growth is expected to remain broadly stable or might even slightly increase, according to our forecasts: the German economy is expected to recover, after contracting in 2023, while Southern Europe (Italy and Spain) should once again boost the Eurozone average. As often, French growth is expected to be in line with the average figure, increasing at the same rate as in the Eurozone in this case. At the same time, inflation in the region plunged in the second half of 2023. Its slight increase in December, to 2.9% y/y, was due to unfavourable base effects on the energy component. The decline in a number of alternative indicators (households inflation expectations and the ECB's PCCI index) is an encouraging sign of disinflation, which has been reflected in particular in the upturn in household confidence (European Commission). The latter climbed to its highest level in almost two years in December.

The labour market continues to defy concerns of a downturn, with the unemployment rate holding firm at an all-time low of 6.4% in November. However, while labour market conditions are likely to deteriorate in 2024, any downturn should be small. For the time being, this trend on the labour market remains in line with the movements in the PMI indices, as the employment index has only dipped slightly since August and remained at around the 50 threshold in December (49.7). Over the same period, industrial activity in the Eurozone has continued to lose ground, after being hit hard by a combination of adverse factors: a slowdown in China and heightened trade tensions with Beijing and increased foreign competition in new sectors (the automotive sector most notably). By November 2023, industrial production had tumbled 7.3% from its September 2022 peak. The latest ECB Economic Bulletin[1] once again put forward the assumption that the manufacturing sector is leading services activity in the cycle. Up until now, the manufacturing downturn is only having limited knock-on effects on other activities.

In response to market expectations around the start and scale of interest rate cuts in 2024, ECB members are looking to play for time. Robert Holzmann, governor of the Austrian Central Bank, who is seen as a "hawk", has even said that the start of the cycle of rate cuts may not happen before 2025 if the tensions in the Middle East were to escalate and their economic repercussions were to worsen[2]. Given the evolving situation in the region, and the initial tangible effects on maritime freight, this scenario unfortunately cannot be completely ruled out. However, the ECB does not believe that inflation will land on its 2% target quickly, which implies that there will be a rather protracted cycle of rate cuts (higher for longer scenario).

GROWTH & INFLATION

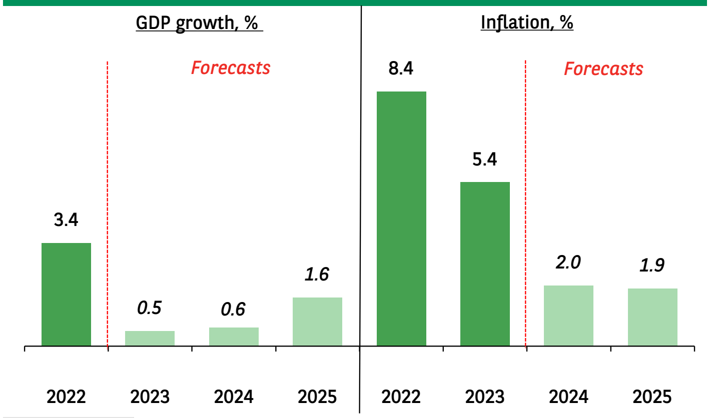

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Its latest macroeconomic projections, dating from December, suggest that inflation will not feasibly return to its target before the second half of 2025, which means that the disinflation phase will be much slower than what we are anticipating. Based on our forecasts, we foresee this to happen in the middle of 2024.

At its most recent monetary policy meeting in December, the ECB also decided to accelerate its quantitative tightening, by starting to reduce its PEPP portfolio by an average of EUR 7.5 billion per month from the second half of 2024, before discontinuing reinvestments under the programme from January 2025. This programme, which was established at the beginning of the COVID-19 pandemic in April 2020, has been substantial, as the total assets held under the PEPP (EUR 1.67 trillion) account for a quarter of the ECB's balance sheet in January 2024, which stands at around EUR 6.9 trillion. Assets held through the public sector purchase programme (PSPP), which is the largest component of the asset purchase programme APP (which was introduced in March 2015 and from which its repurchases discontinued in December 2018), amount to EUR 2.4 trillion, which is just over a third of the ECB's balance sheet.

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1 See Monetary policy and the recent slowdown in manufacturing and services, ECB Economic Bulletin, January 2024
2 See ECB's Holzmann Warns Rate Cuts Aren't Guaranteed This Year, Bloomberg, 15 January 2024