A TWO-SPEED ECONOMY

Economic activity in the Eurozone is expected to gradually pick up over the course of 2024, buoyed by improving household purchasing power and falling interest rates. However, the industrial sector in the Eurozone is facing major structural problems, which will not (or will only slightly) be addressed by lowering the ECB's policy rates. The ramp-up of the EU's recovery fund should, in theory, enable southern Eurozone countries, which are the main recipients, to outperform again in 2024. However, so far, its effects have been relatively limited and the implementation problems, as highlighted in a recent European Commission report, will not go away completely this year.

Downside risks to growth in the Eurozone are mainly in the industrial sector, where the downturn in activity has showed no signs of stabilising this winter. Industrial production shrank significantly in January, falling to its lowest level in three and a half years, while the PMI indices for the sector continued to contract sharply (45.7 in March). In March, the PMI employment sub-index fell to its lowest level since August 2020, raising fears of a larger downturn in recruitment trends in this sector. The fall in industrial employment in the Eurozone needs to be halted before any turnaround can occur. This has not happened yet, as manufacturing employment levelled off in the second and third quarters of 2023, before falling 0.1% q/q in the last quarter. As a result, the share of industrial employment in the Eurozone hit its lowest ever level, at 12.8%, during the final quarter of 2023 (see chart).

However, job creation remained dynamic in a number of service sectors (information and communication, retail and wholesale trade, accommodation and public services), as well as in construction. The pressure on the labour market is expected to remain high in 2024, as evidenced by the Eurozone job vacancy rate, which, despite falling to 2.8% in Q4 2023, still remained far higher than its pre-COVID level.

After stabilising, Eurozone inflation fell again in March, to 2.4% y/y, according to Eurostat's preliminary estimate. Inflation is expected to get close to the 2% target in the second quarter of 2024, which would give the ECB more leeway to start cutting rates in June. This is expected to be followed by two further cuts by the end of 2024, which would be a moderate pace, and would continue into the first half of 2025.

Nevertheless, ECB members are trying to maintain a fairly firm line around their objective of price stability by focussing more on the trajectory in unit labour cost (ULC) as a key decision-making factor[1]. ULCs are calculated based on wage trends, but also based on other employee-remuneration components (including employer social security contributions) as well as productivity gains. Therefore, it is a more accurate measure than wages for assessing the pressure on companies' margins and their ability to absorb a rise in their costs. However, hourly labour productivity in the Eurozone fell by an annual average of 1.0% in 2023, according to Eurostat data, which led to an acceleration in ULCs (+5.8% y/y in Q4 2023, compared to 4.6% in Q4 2022) when, by contrast, harmonised inflation slowed down significantly (2.6% y/y in Q4 2023, compared to 8.0% in Q4 2022). Companies' margins, which, as a whole, had risen sharply in 2021-2022, gradually fell during 2023. If this trend continues, it would force more companies to adjust their prices, fuelling higher inflation as a result, assuming that the demand environment allows it.

Furthermore, the positive effects of the deployment in the European Union's Recovery and Resilience Facility (RRF) have not yet been clearly seen on the ground. Although investment excluding housing in the Eurozone was up by 3% in 2023, it is still 5% below its pre-pandemic level. In a mid-term evaluation[2], the European Commission highlights a number of obstacles in distributing these funds on the ground (administrative complexities, operating costs, centralised decision-making and a lack of consultation with all stakeholders). The report also points to the risk of substitution between the RRF and other European Union programmes, notably the Cohesion Policy. The RRF is expected to be ramped up this year, but there is still a risk that it may not in fine deliver as strongly as intended due to a lack of synergy between EU and national budgets.

GROWTH & INFLATION

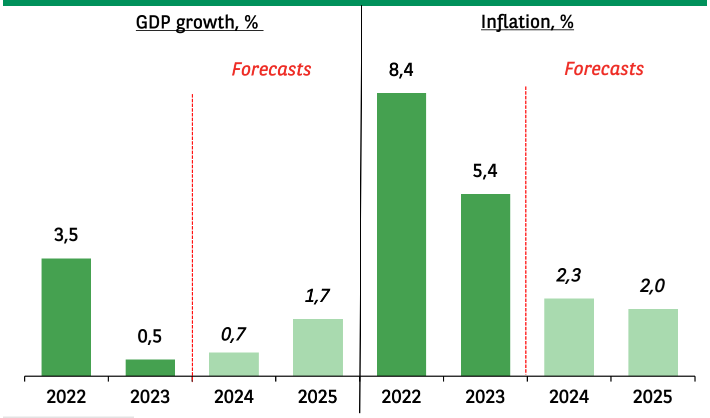

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EUROZONE: MANUFACTURING EMPLOYMENT

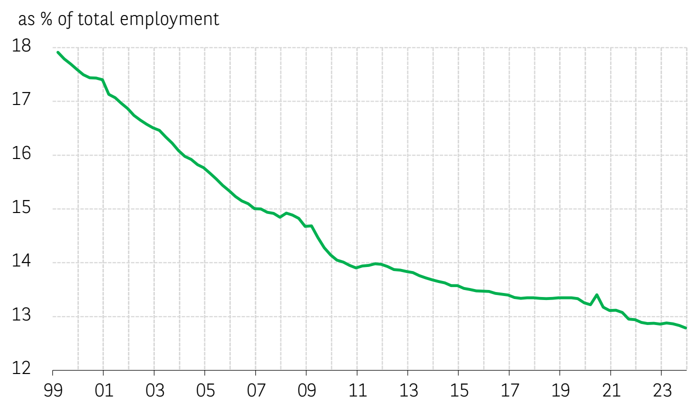

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS

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1 See, for example, the interview with Luis De Guindos on 19 March 2024: Interview with Naftemporiki (europa.eu).
2 Mid-term evaluation of the Recovery and Resilience Facility (RRF) - European Commission (europa.eu)).