EUROZONE: STARTING THE YEAR ON AN UPBEAT NOTE

The drop in gas prices, the decline in headline inflation and the improvement of survey data in December have created a feeling that for the Eurozone 2023 might be better than expected hitherto. The survey data bode well for the growth momentum at the turn of the year, which could create a favourable carry-over effect for GDP this year and some hope that lower inflation will mean fewer ECB rate hikes. However, caution is warranted. Inflation remains far too high and core inflation has moved higher in December. Moreover, survey data provide little or no information on the pace of growth beyond the first quarter of this year.

We're only one week into the new year but there is a growing feeling that for the Eurozone 2023 might be better -or less bad- than expected. Gas prices (chart 1) have dropped to pre-war levels -on the back of a warm winter thus far, very high inventory levels and cutbacks in gas use-, headline inflation was negative in December versus November -a decline of -0.3% against a Bloomberg consensus of +0.8%- and both the manufacturing and services purchasing managers' indices increased in December, respectively to 47.8 and 49.8, bringing the composite PMI to 49.3.

In addition, the European Commission's economic sentiment indicator rose for the second month in a row in December[1]. Unsurprisingly, European equities are up year-to-date with the EuroStoxx 50 outperforming the S&P500 (chart 2). These developments and data have led several commentators to argue that the recession would be shallower than expected hitherto.

Although the likelihood has indeed increased, caution is warranted. Some arguments are in favour of a 'bull' case -a shallower recession- but others argue for a 'bear' case, meaning that it's too early to become more optimistic. The thinking underpinning the more positive assessment runs as follows. The drop in oil and gas prices will benefit households and firms and should accelerate the pace of disinflation this year, which in turn should lead to slower and/or more limited monetary tightening. Moreover, the rebound of the composite PMI in December bodes well for real GDP growth in the final quarter of 2022 and the first quarter of this year.

However, this rosy picture should be nuanced. Firstly, headline inflation has started to decline in the Eurozone, but the gap with the ECB's target remains huge (chart 3). Moreover, core inflation has accelerated in December, both on an annual and monthly basis (chart 4). Secondly, gas prices may increase again later this year when inventories need to be replenished. Thirdly, the hawkish tone after the December governing council meeting has been followed by messages showing that the tightening job is far from over.

1 The Economic Sentiment Indicator (ESI) is a composite indicator combining results of surveys in industry, construction, retail trade, services as well as amongst consumers. Source: European Commission.

GAS AND OIL PRICES

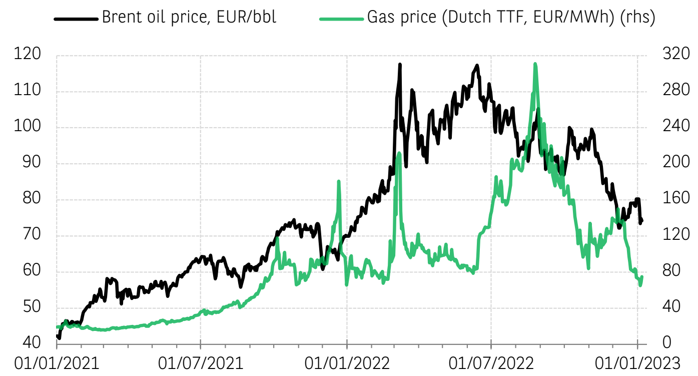

CHART 1 SOURCE: REFINITIV, BLOOMBERG, BNP PARIBAS

STOCKMARKET VALUES IN THE FIRST DAYS OF 2023

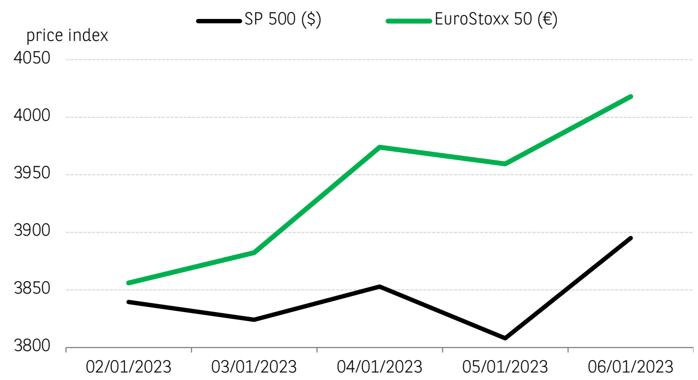

CHART 2 SOURCE: S&P, STOXX, BNP PARIBAS

> Recent survey and inflation data, in combination with the drop in the price of gas, have fueled hope that the recession would be shallower than expected hitherto. Although the likelihood has indeed increased, caution is warranted.

EDITORIAL

François Villeroy de Galhau, governor of the Banque de France, recently stated that *"after raising interest rates to close to the "neutral interest rate" of 2% in December, we are now embarking on the second phase towards monetary stabilization: ideally, it would be good to reach the right "terminal rate" by next summer, but it is still too early to say what that level will be."*[2] He also mentioned the role of core inflation in determining the appropriate stance of monetary policy. His colleague at the Dutch central bank recently commented that the ECB had *"only just passed the halfway point of its tightening cycle and needs to be 'in there for the long game' to tame high inflation."*[3]

Finally, one should avoid reading too much in the recent data. The December rebound of the composite PMI and the increase of the European Commission's economic sentiment indicator is of course good news: GDP growth at the turn of the year could be better than expected and create a positive carry-over effect for this year's GDP. However, the survey data provide little or no information what this could mean for GDP growth beyond the first quarter of this year. As shown by the table, the relationship between growth and the composite PMI is only significant in the current quarter (T) and the next quarter (T+1)[4].

Beyond that, the PMI provides no statistically significant information about real GDP growth. Even for the current and next quarter, caution is warranted considering that, as shown by the low adjusted R^2, a large part of the fluctuations in growth are not explained by what happens with the PMI. Besides, the European Commission survey is only statistically significant for estimating growth in the current quarter. To conclude, the recent data are clearly good news for the near term, but beyond that, caution should prevail.

William De Vijlder

EUROZONE: HEADLINE HICP INFLATION

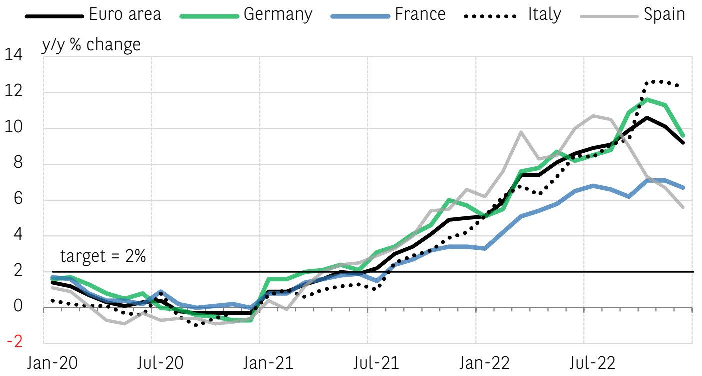

CHART 3 SOURCE: EUROSTAT, BNP PARIBAS

EUROZONE: CORE HICP INFLATION

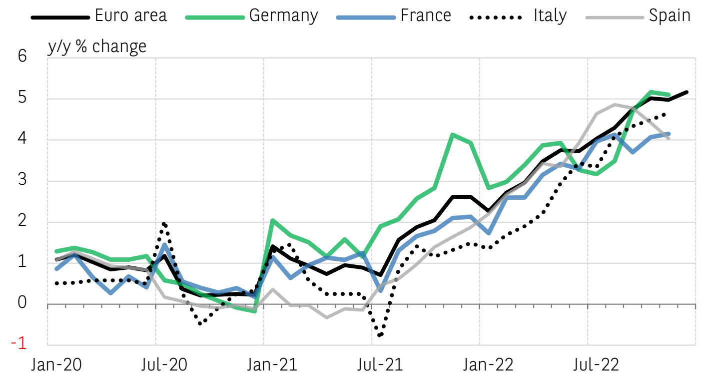

CHART 4 SOURCE: EUROSTAT, BNP PARIBAS

EUROZONE: REAL GDP GROWTH AND COMPOSITE PMI*

	T	T+1	T+2	T+3
Beta	0.14	0.18	-0.07	0.03
t statistic	3.75	4.93	-1.75	0.72
adjusted R^2	0.12	0.20	0.02	-0.01

*REAL GDP GROWTH (QOQ) IN % AS A FUNCTION OF THE COMPOSITE PMI IN THE FINAL MONTH OF THE QUARTER.

TABLE 1 SOURCES : S&P GLOBAL, EUROSTAT, BNP PARIBAS. DATA START IN SEPT.1998

2 Source: New Year wishes 2023, Speech by François Villeroy de Galhau, Governor of the Banque de France, Chairman of the ACPR, Paris, 5 January 2023.
3 Source: Leading ECB policy maker hints at sharp climb to peak rates, Financial Times, 26 December 2022.
4 The composite PMI for the final month of a given quarter has been used to produce a forecast of quarterly GDP growth for the same quarter (T) and the following quarters (T+1, T+2, T+3). A similar analysis using the European Commission's economic sentiment indicator only shows a significant relationship for the same quarter but not for the following quarters.