WILL THERE BE A GROWTH OUTAGE THIS WINTER?

It seems highly likely that for the eurozone, 2023 will bring an easing in inflation, a contraction in GDP and a peak in the ECB's policy rates. The uncertainties lie in the scale of disinflation and of the recession, and in the level and timing of the peak in rates. According to our forecasts, the fall in inflation will be rapid on the surface (with headline inflation dropping from around 10% y/y in Q4 2022 to 3% in Q4 2023), but this will mask a slower fall in core inflation, which we expect to remain above 2% in a year's time, from 5% at present. In the face of this persistent inflation, we expect the ECB to hike its deposit rate by 100bp, to 3%, by the end of Q1 2023 and then maintain this restrictive level throughout the year, despite the recession. The recession, meanwhile, is expected to be shallow and short-lived, thanks in particular to fiscal support and the resilience of the labour market, which both allows and justifies the ECB's restrictive approach.

RECESSION LOOKS INEVITABLE...

Although eurozone growth provided another positive surprise in Q3 (up 0.3% q/q, taking the growth carry-over to 3.4%) and thus dodged the expected contraction, repeating this performance in the current quarter, and also the next two, is a tougher task. A recession is not a certainty, but we believe it is inevitable. Although consumer confidence saw some small signs of improvement in October and November, it remains depressed. The deterioration in business climate surveys remains relatively well contained, but in absolute terms are still pointing towards a contraction in activity (Chart 2). Above all, we are expecting that their decline will continue as we have not yet seen the full effects of the inflationary shock, the energy crisis and monetary tightening.

...BUT IT COULD BE SHALLOW AND SHORT

A severe and prolonged recession can not be ruled out given the unprecedented accumulation and scale of the shocks listed above. But for the time being we believe that the most likely scenario is a shallow and short-lived recession. Thus we expect GDP to contract by -0.4% q/q in Q4 2022, then -0.5% in Q1 2023 and -0.2% in Q2 2023 before a modest recovery in the second half. In annual average terms, we expect GDP growth of 3.2% in 2022, followed by a contraction of -0.5% in 2023 and then a recovery to 1.3% in 2024.

The first of the factors containing the expected recession is the substantial fiscal support introduced at the national and European levels (Chart 3). In the short term, economic activity should continue to be supported by the continued catching up from the pandemic in sectors where this is not yet complete, although this effect is not far from reaching its end. The easing of supply chain difficulties, allowing the order backlog to be addressed, is another factor in supporting the economy. More broadly, the extra savings built up by households during lockdown periods and the relatively good financial situation of businesses at the beginning of 2022 aresignificant shock absorbers: households and companies have had something of a buffer to absorb the current shocks and this will remain the case, albeit to a lesser extent as the shocks have started to eat into these reserves.

The scale and urgency of investment needs, particularly in the areas of digital technology and the energy transition, are another source of substantial support to growth, although these could be limited by hiring and skills constraints and less favourable financing conditions. This wave of green investment could help in a soft landing for the economy similar to that seen in the second half of the 1990s, when investment in new information and communications technologies contributed to a soft landing for the US economy.

GROWTH & INFLATION

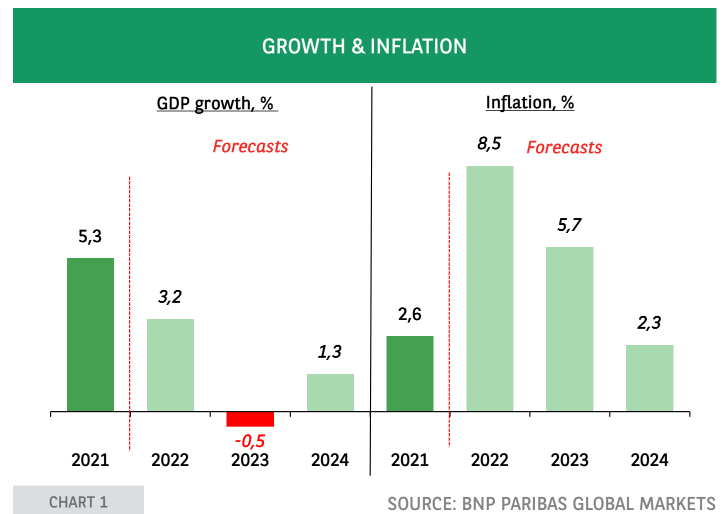

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EUROZONE: COMPOSITE PMI AND ECONOMIC SENTIMENT INDICATOR

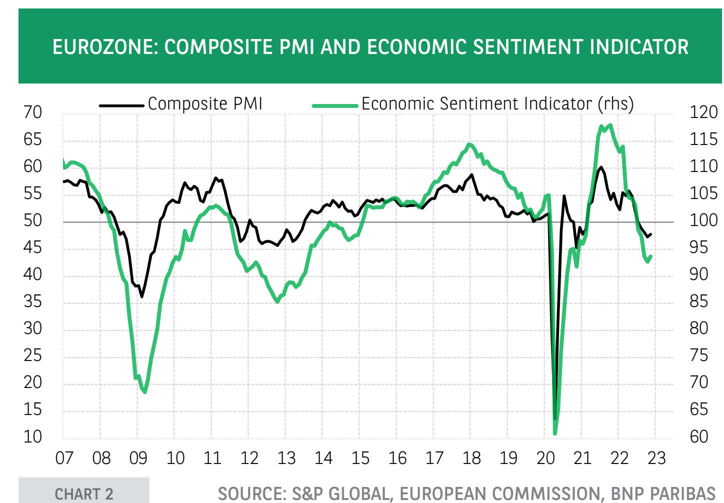

CHART 2 SOURCE: S&P GLOBAL, EUROPEAN COMMISSION, BNP PARIBAS

The relatively good performance of the labour market thus far has been encouraging. We also see the persistent hiring difficulties (in part a reflection of the strength of employment) as a specific and significant source of resilience to the slowing of activity in this cycle; it will encourage companies to hoard staff. We are counting on these elements to limit the predictable increase in unemployment rates and the knock-

on effects of the deterioration of the labour market on activity. In our scenario, the limited contraction in the economy and in employment will feed into each other.

The disinflation expected in 2023 represents another source of support, by easing the downward pressure on confidence, consumer purchasing power and company margins. Disinflation will also signal the end of policy rates hikes, which should also have a positive effect on expectations and behaviour.

SOURCES OF SUPPORT BUT DOWNSIDE RISK AS WELL

Our forecast for 2022 is in line with the December consensus average, but it is more negative for 2023 (by 0.4 of a point, bearing in mind that the consensus range is broad, from a high of +1.3% to a low of -1.4%). Although our scenario is relatively negative, we think that the risks still lie on the downside. The reaction of company margins, the labour market, real estate markets and the financial sphere to the ongoing shocks could be more negative than expected, with a possible additional contagion effect coming from the USA, where the expected recession will come later than that in the euro zone (between Q2 and Q4 2023). The extent of disinflation remains uncertain. The Covid-19 pandemic remains a significant risk factor.

A financial shock, coming on top of the others, cannot be ruled out. Bank balance sheets are certainly more solid and consumers and companies are not more indebted than in 2007[1] , on the eve of the subprime crisis, but government debt is much higher. And there are sizeable vulnerabilities amongst unregulated financial actors, in the more risky market segments and in those where liquidity could suddenly dry up.

The supply of energy, particularly gas, continues to hang over Europe like a particularly hefty sword of Damocles. This risk, which is specific to the eurozone, comes on top of an energy price effect that is already much higher than in the USA, for example, and as high as it was during the oil shocks of the 1970s[2] . The deterioration in the terms of trade and the associated loss of real income are even higher according to estimates from the ESM (European Stability Mechanism): in Q1 2022 this loss was estimated at 1.7% of GDP, a figure that was already higher than the 1.3% loss calculated for 1974 and which can only have increased since, given further rises in energy prices.

Lastly, central banks face the hefty challenge of calibrating monetary tightening: neither too much, which would damage growth, nor too little which would prevent inflation from being swiftly brought under control. Although our scenario assumes that they will rise to this challenge, the risk of mistakes is not inconsiderable. In its October 2022 World Economic Outlook, the IMF estimated at 25% the probability that global growth in 2023 will be less than 2% (something that has happened only five times since 1970, in 1973, 1981, 1982, 2009 and 2020): the high level of this probability illustrates the scale of downside risks[3].

THE ECB IS DETERMINED

With its 50bp rate increase at its 15 December meeting (after successive 75bp increases in September and October), the ECB marked the first turning point in the monetary tightening cycle it began in July, made possible by the first encouraging signs in the expected disinflation coupled with more unfavourable signals on the growth front.

FISCAL RESPONSE TO THE INFLATIONARY SHOCK AND ENERGY CRISIS

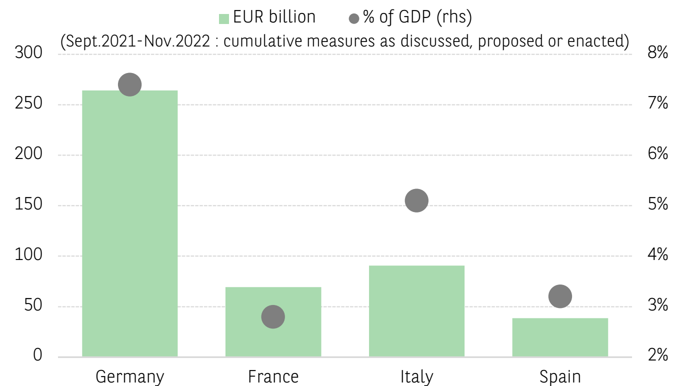

CHART 3 SOURCE: NATIONAL GOVERNMENTS, BRUEGEL DATASETS (LATEST UDPATE: 29/11/2022), BNP PARIBAS

EUROZONE: LABOUR BOTTLENECKS AND UNEMPLOYMENT RATE

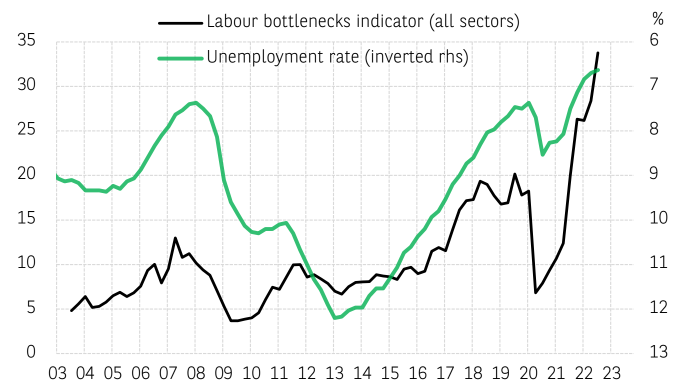

CHART 4 SOURCE: EUROPEAN COMMISSION, EUROSTAT, MACROBOND, BNP PARIBAS

Although it is nearing an end, the tightening cycle is not there yet: we are expecting the ECB to make two further rate increases in February and March 2023, of 50bp each, taking the deposit rate to 3% and the refinancing rate to 3.50%.

We expect the ECB will then hold them at this restrictive level throughout 2023, despite the recession, in the absence of core inflation falling sufficiently close to the 2%-target by the end of next year. To strengthen its action, the ECB will make another important monetary shift in 2023, with quantitative tightening (QT) beginning to shrink its balance sheet. This normalisation, in contrast to the rapid and large hikes in interest rates, is likely to come in progressive steps. The ECB will have to balance flexibility and predictability.

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1 According to data compiled by the Banque de France (% of GDP).
2 According to data from BlackRock Investment Institute, drawn from BP's statistical review of world energy, which compares the weight of oil, gas and coal consumption to GDP (in USD). In 2022, this ratio was 11.7% for the EU and 5.3% for the USA, from 12% and 10% respectively in 1980.
3 This low scenario from the IMF would come about under the plausible combined effect of an unexpected fall in global oil supplies, an additional weakening in the Chinese real estate market, continued labour market tensions and tighter financing conditions (see box 1.3, pp 33-36, WEO October 2022).