GROWTH AND INFLATION SURGE

After rebounding vigorously in Q2 (+2.2% q/q), GDP growth is expected to maintain the same dynamic pace in Q3. Admittedly, supply-side constraints have just chipped away a few tenths of a percentage point of growth from our June forecast. September's business climate surveys are showing more traces of these tensions, especially in industry, and in Germany in particular. Even so, the survey results are still holding at high levels. Growth in the Eurozone will get a boost from the monetary and fiscal accommodation, the freeing of forced savings built-up by households, the recovering job market and the need for investment. We expect 2022 growth to be slightly higher than in 2021 (5.2% and 5%, respectively, in annual average terms). However, the optimism of the big picture is somewhat tarnished by the simultaneous surge in inflation, even though a rather large part is only temporary. The ECB is expected to continue giving priority to growth. It will only make minimal efforts to begin normalising monetary policy by letting the Pandemic Emergency Purchase Programme (PEPP) expire in March 2022. Moreover, it should be offset by a larger and more flexible Asset Purchase Programme (APP). But the ECB is also signalling that is being vigilant about inflationary risks.

GROWTH SURGES

After contracting slightly for two quarters (-0.4% q/q in Q4 2020 and -0.3% in Q1 2021) due to lockdown measures in various Eurozone countries, growth rebounded vigorously in Q2 2021 (+2.2% q/q, +14.3% year-on-year). This brings the growth carry-over to nearly 4%, while the shortfall from the pre-crisis level of Q4 2019 has narrowed to 2.5%. The rebound in household consumption (+3.7% q/q) explains 85% of this growth. Investment also made a positive but smaller contribution (0.3 points vs. 1.9 points for consumption). Net exports did not contribute to growth since strong export growth was accompanied by an identical rise in imports, reflecting the strength of domestic demand. Changes in inventory made a negative contribution of 0.2 points.

Comparing the performances of the four biggest member states, Italy reported the biggest rebound (+2.7% q/q), followed by Germany (+1.6%), France and Spain (+1.1%). For the Eurozone as a whole, Ireland was the leader of the pact (+6.3%) while Malta lagged behind (-0.5%). As to the gap between GDP and the pre-crisis level (see chart 2), Germany and France reported the smallest shortfalls (3.3% and 3.2%, respectively), followed closely by Italy (-3.8%), while Spain still has a long way to go before closing the gap (-8.4%). In comparison, GDP growth in the United States has already surpassed the pre-crisis level (+0.8%) while the UK is still relatively far behind (-4.5%).

The vigorous rebound in Q2 growth was already visible in the upturn in confidence surveys between April and June, for both Markit's PMI and the European Commission's Economic Sentiment Index (ESI). In July, the composite PMI and the ESI both rose another notch, with the PMI reaching the highest level since mid-2006 (60.2) and the ESI setting a new record high of 119.

In August, the two surveys dipped slightly lower. The PMI indices for September (Flash estimates) declined more sharply, which can be attributed to the impact of supply-side disruptions and upward pricing pressures at work since late 2020 and early 2021. At the aggregate level for the Eurozone, manufacturing PMI declined 3.3 points to 55.7 (output component), which is slightly sharper than the 2.7-point decline in the services PMI (to 56.3). Geographically, PMI declined more sharply in Germany than France.

Even so, these PMI levels are still consistent with strong Q3 growth, which we expect to be similar to the Q2 figure, before beginning to normalise in Q4 (+1.2% q/q). Various supply-side constraints have chipped off a few tenths of a percentage point of growth from our June forecast, but the sting has been fairly mild so far, and the lost ground should be gradually recovered in 2022. Assuming that demand will be less vigorous and that health restrictions hampering production will be loosened, our scenario makes the implicit assumption that supply disruptions and pricing pressures will not get a lot worse, and will not spread to other product categories. Yet this scenario is shrouded in uncertainty.

GROWTH AND INFLATION (%)

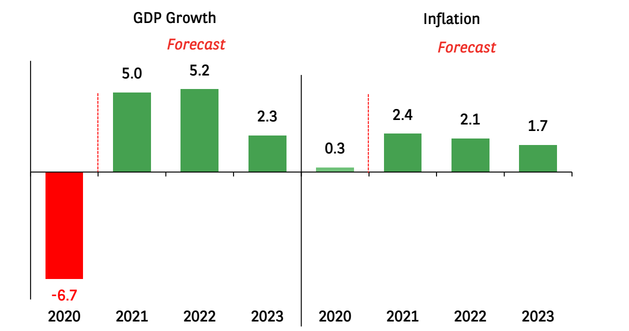

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP: DEVIATION FROM PRE-CRISIS LEVEL

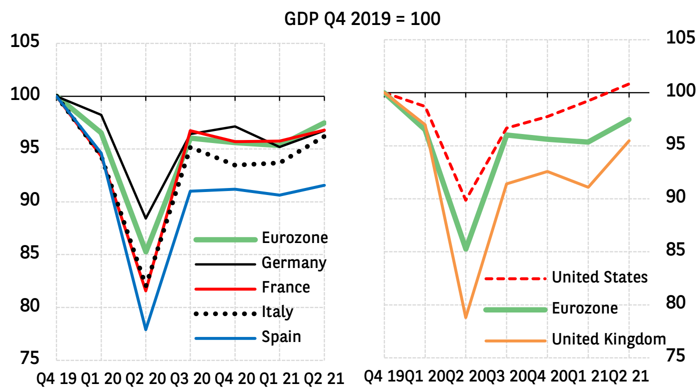

CHART 2 SOURCE: INSEE, EUROSTAT, BEA, ONS, BNP PARIBAS

The positive momentum in hiring, investment and pricing behaviour reflects the corporate sector's confidence in the robustness of growth prospects and its capacity to pass on higher input prices to output prices in order to preserve mark-ups. Yet this confidence must be monitored closely.

In 2022, the quarterly growth profile will slow down slightly. More importantly, however, it should remain significantly higher than the long-term trend, bolstered by the monetary and fiscal accommodative stance, the recovering job market, the unblocking of forced savings accumulated by households, and investment needs. Average annual growth is expected to be slightly higher in 2022 than in 2021 (5.2% and 5%, respectively), which sets the Eurozone apart from the United States and the UK. Germany and to a lesser extent Spain are expected to report stronger growth in 2022, while France and Italy are both expected to slow. Our 2021 forecast is identical to that of the ECB and the September consensus, while our outlook for 2022 is 0.6 and 0.8 points higher, respectively. The health situation remains an important downside risk, followed by the negative impact of supply-side constraints and the surge in inflation, to which we must add new fears about the scope of China's economic slowdown.

INFLATION GALLOPS

Since year-end 2020, Eurozone inflation has been on a distinctly upward slope. Twelve months ago, year-on-year inflation was still slightly negative, but in August 2021, it rose to +3%, the highest level since year-end 2011. The surge is strongest in Germany, followed by Spain, Italy and France (see chart 3). Yet it is still too early to speak of the return of inflation, since price increases have not spread to all components of the consumer price index, and they are not self-sustaining. Core inflation is much lower at 1.6% y/y. The increase in inflation is essentially due to a temporary relative prices distortion. A major base effect is at work, linked notably to energy prices. There is also the impact of supply-side constraints on the prices of certain commodities and industrial inputs, and the impact of surging demand for certain products following the end of lockdown measures. These upside pressures should dissipate in 2022.

Before ebbing, however, inflation is expected to continue rising through the end of the year. We expect inflation to peak in Q4 (as it verges on 4% y/y). This is bound to have an impact on corporate margins and household purchasing power. Yet signs of output prices increases and the generally well preserved financial situation of companies should help limit the negative impact on margins. And the impact on household confidence and consumption is likely to be mitigated by the large surplus savings available for them to dip into, as well as by the support of a healthier job market and by various fiscal support measures for households.

Another factor to watch for is the transmission of inflation to all components of the CPI and the triggering of a wage-price loop against a backdrop of strong hiring difficulties, which could lead to much higher inflation for longer. Yet the odds of such a scenario seem low given competitive pressures and the need to preserve market shares; as well as the high unemployment halo (which includes inactive people who are discouraged about finding work and those working part time but would like to work more). For the moment, there are no visible signs of second-round effects, nor really any need to fear them.

HARMONIZED INFLATION

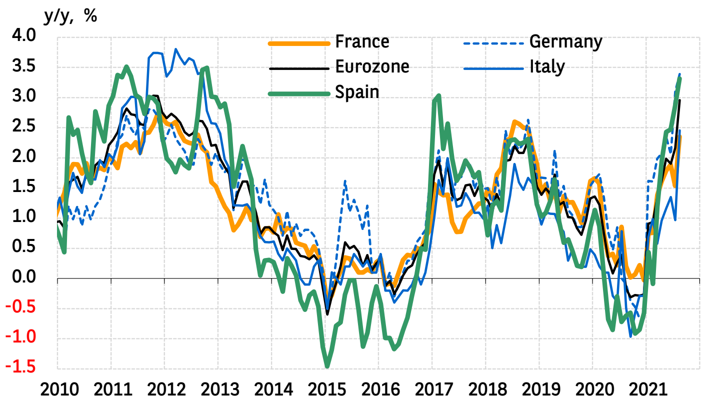

CHART 3

SOURCE: EUROSTAT, BNP PARIBAS

Naturally, the ECB is being vigilant, but we believe it might also welcome the return of some self-sustaining inflation. It would signal that growth is strong and that its "reflation" efforts have been effective. Inflation would finally approach the central bank's target. A little more inflation is also a way to oil the wheels of the economy and to facilitate certain adjustments[1]. In this case it would be "good" inflation. This is the basis of our scenario and inflation forecasts (2.4% in 2021, 2.1% in 2022, and 1.7% in 2023), which are slightly higher than the ECB ones (2.2%, 1.7% and 1.5%, respectively).

Completed on 27 September 2021

Hélène Baudchon
helene.baudchon@bnpparibas.com

EUROPEAN CENTRAL BANK

We expect the ECB governing council to decide at its December meeting to stop the net purchases under the PEPP in March next year and to increase the purchases in the context of the APP in order to avoid market disruption. This should also limit the spillover effect of higher US Treasury yields on Eurozone sovereign yields. We do not expect a rate hike over our forecast horizon, which runs until 2023.

The forward guidance on interest rates has set three key conditions that should be met before interest rates can be raised: the ECB should see inflation reaching two per cent well ahead of the end of its projection horizon, inflation should reach two per cent "durably for the rest of the projection horizon" and underlying inflation should be judged to have made satisfactory progress towards the target. With the exception of inflation in 2021 – which meets the first condition–, based on the ECB staff projections, none of the conditions are met over the projection horizon, not even in a more favourable alternative scenario.

William De Vijlder
william.devijlder@bnpparibas.com

1 *Inflation is back with a vengeance — but is that a bad thing? Financial Times* (ft.com).