EUROZONE

HEADING FOR A RECESSION ?

The current unprecedented combination of shocks (inflation, health crisis, geopolitical issues, energy crisis, climate, monetary issues) is likely to overburden the Eurozone resilience and push the region into recession over the coming quarters. The deterioration in confidence surveys this summer provides an early indication of this likely outcome. However, we expect the recession to be limited in scope, in large part due to budgetary support. This recession should be followed by a moderate recovery as the various shocks start to ease. Faced with the continued surge in inflation, the ECB has moved up a gear. It will probably raise its rates by a further 125 bps by the end of the year (bringing the deposit rate to 2%) and then wait and see thereafter, allowing time to assess the extent of the decline in growth and in inflation.

At the time of writing it is still difficult to be certain, but a recession in the Eurozone over the coming quarters does seem inevitable. Or to be more precise, such a scenario now seems more likely than a scenario without a recession. After a better-than-expected first half of the year (bringing the growth carry-over to 3.2% in Q2 2022), the current unprecedented combination of shocks (inflation, health crisis, geopolitical issues, energy crisis, climate, monetary issues) is likely to overburden the resilience seen to date.

There are already early signs of this in confidence surveys. The deterioration in the business climate is not as pronounced as the decline in householder confidence, but it is starting to reach warning levels. The composite PMI in the manufacturing sector fell below the 50 threshold in July and has continued to fall in August (49.6). The figure for the services sector was only a hair's breadth away according to the flash estimate for August (50.2), following four consecutive months of quite marked decline, and the final estimate, revised downwards, pushed it through the threshold (49.8). The Eurozone's Economic Sentiment Index (ESI) also fell sharply in July (a generalised fall across all sectors), falling below the benchmark 100 threshold, and then fell further in August (a decline that concerned only industry and the services sector).

We also expect these surveys to continue their downward trend over the next few months, or even to fall more steeply. The energy savings needed to cope with the unfolding energy crisis will weigh on activity. And the deterioration in the business climate is probably not yet fully reflective of the extent of the negative impact, in view of the rise in the examples of struggling businesses / sectors, due to the accumulation of problems and their propagation across the economy.

For the time being, employment prospects based on surveys are only starting to be a little less positive. Factors such as the healthy pace of job creation in the first half of the year (which has helped employment to exceed by 2% its pre-pandemic level), the continued decline in the unemployment rate over a year and a half (6.6% of the labour force in July) and the ongoing hiring difficulties mean it is possible to temper concerns somewhat. The recession towards which the Eurozone seems to be heading could just be "technical", i.e. limited to two quarters of moderate decline in GDP (-0.2% q/q in Q3 and -0.3% q/q in Q4 2022 based on our forecasts). The healthy tourism season and the budgetary support measures are also significant short-term cushioning elements (which could also push back the recession to Q4 2022 and Q1 2023). This limited expected contraction also presupposes that the energy crisis will remain under control, which is by no means certain. The adaptability of companies, their generally favourable financial situation before the war in Ukraine, the savings buffer available to some households and the need for investment to decarbonise the economy are, however, more reliable supportive elements.

In 2023 the fading of the various shocks should allow a moderate upturn in growth. Our growth forecasts for 2022 and 2023 are very close to the September consensus mean (0.1 point below in 2022, 0.1 point above in 2023). But the wide dispersion of forecasts for 2023 (+1.3% / -0.8%) illustrates the uncertainty and the difficulty in fully understanding the current situation and how it will develop.

GROWTH & INFLATION

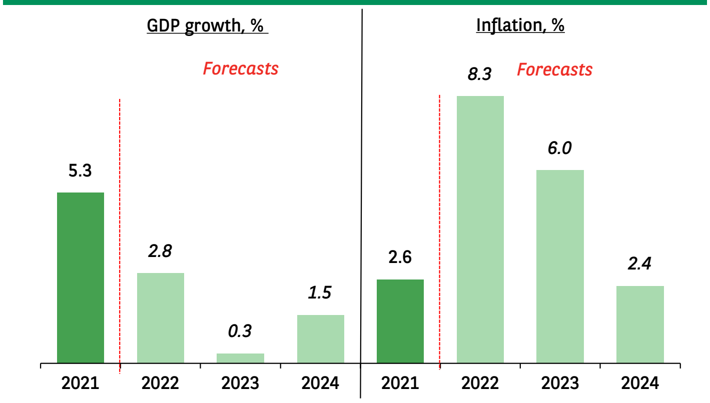

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The inflationary situation remains difficult. Some of the upstream inflationary pressures are certainly easing (delivery times, input prices, oil) but it may take time before their downward impact on inflation becomes visible, particularly as they are offset by inflationary pressures which are continuing to increase (gas and electricity prices, food prices, lagged effects of past price rises, wages, euro). The elevated level and generalisation of inflation have made it persistent and therefore more difficult to reduce. According to our forecasts the peak should be near – inflation is likely to be around 10% year-on-year in September – but it should remain around this rate until the end of the year and there remains considerable uncertainty about the timing and the level of this peak. In our scenario, inflation should start to fall a little more sharply from spring 2023. However, it would still be around 3% at the end of 2023 and would only reach the ECB's target at the end of 2024.

Faced with the continued rise in inflation, the ECB has moved up a gear and raised its key rates by an exceptional 75 basis points at its meeting on 8 September. However, this move, which is not intended to become the norm, may be followed by another of the same magnitude on 27 October and by +50 bps on 15 December. The deposit rate would then reach 2%, i.e. the estimated level of the neutral rate. We then expect the ECB to stay at that level, allowing time to assess the extent of the delcine in growth and inflation (with the risk, however, of having to do more in view of the expected slow pace of disinflation).

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