# THREE 'CERTAINTIES', MANY UNCERTAINTIES

**From an economic perspective, 2022 will go down in history as the year in which elevated inflation made a surprising comeback forcing major central banks to start an aggressive tightening cycle. It is highly likely that in twelve months' time we will look back at 2023 as a recession year, a year of disinflation, and a year in which official interest rates reached their terminal rate and stayed there. As usual, the list of 'known unknowns' is long. Energy prices might increase again after their recent decline, disinflation might be slower than expected, policy rates might peak at a higher level than currently priced by markets, and the recession might be deeper and longer than anticipated. However, we should also pay attention to factors of resilience: companies hoarding labour, thereby limiting the rise in unemployment, the support from fiscal policy in many European countries, the need to invest in the context of the energy transition.**

Economists seldomly use the word certainty when commenting their forecasts. After all, economic activity is so dynamic and subject to unforeseen events that projections are often, if not always, surrounded by a high degree of uncertainty.

Looking at 2023, the list of 'known unknowns' is long but, focusing on the US and the Eurozone, there are also 'certainties', i.e. developments that are highly likely to occur. The first one is disinflation, which refers to a sustained decline in headline inflation. A key driver is a favourable base effect. Following the recent and expected evolution of energy prices, their contribution to headline inflation should decline quite a lot. In its latest projections, the ECB expects the contribution of energy to annual inflation to drop from 3.8 percentage points in 2022 to 1.6 percentage points in 2023. In addition, easing supply chain pressures -shorter delivery times, deceline of input price inflation- and subdued demand, which should weigh on the pricing power of companies, should also contribute to a decline in inflation.

The second 'certainty' is the peak in central bank policy rates. Rate hikes in 2022 have been front-loaded, which means that the pace and extent of tightening has been swifter than in previous cycles. It also implies that the terminal rate should be reached more quickly. This stance has been motivated by the huge inflation overshoot -the gap between observed and target inflation- and the need to bring inflation expectations, which had been drifting higher, rapidly under control.

Finally, we forecast a recession in the Eurozone, which we see as inevitable, with three quarters of negative quarter-on-quarter growth starting in Q4 of 2022. Survey data have already reached a level that corresponds with negative quarterly growth (chart 1). In the US, we expect a recession of similar length but starting later, in Q2 2023. The decline of the index of leading indicators is also pointing in that direction (chart 2). The latest ECB projections also have a recession -short-lived and shallow- but in the US, Federal Reserve Chairman Powell preferred not to express a view on the matter in his recent press conference.

With these 'certainties' come many more uncertainties. Top of mind is of course how the war in Ukraine might evolve and what this could mean for the economy. Another question concerns inflation, where risks continue to be tilted to the upside, meaning a slower than expected pace of disinflation.

Even if energy prices were to remain stable, past increases could still fuel inflation. As old, fixed-price energy contracts come up for renewal, the ensuing cost increase for companies could be reflected to some degree in higher sales prices. However, this depends on the price elasticity of customer demand, at least if alternatives are available. If disinflation disappoints, investors might expect a higher terminal rate for central bank policy rates.

EUROZONE: GDP GROWTH AND ECONOMIC SENTIMENT INDICATOR

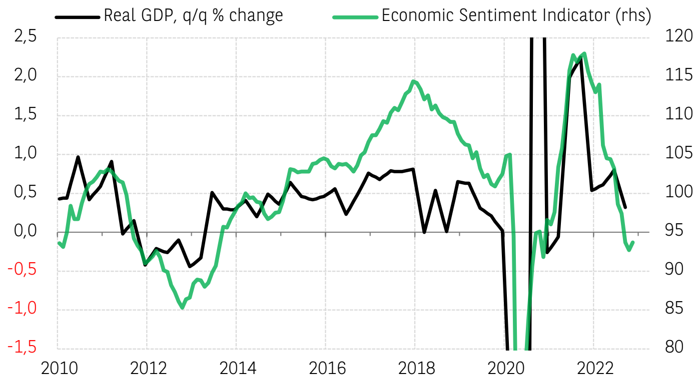


CHART 1 SOURCES : EUROSTAT, EUROPEAN COMMISSION, BNP PARIBAS

US CONFERENCE BOARD LEADING ECONOMIC INDEX

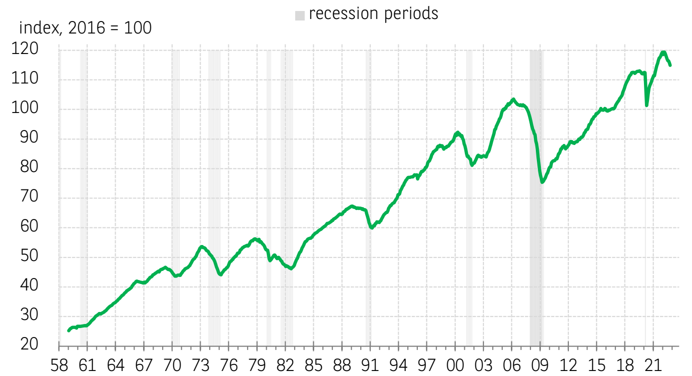


CHART 2 SOURCE: CONFERENCE BOARD, NBER, BNP PARIBAS

This could weigh on financial markets -higher bond yields, lower equity prices- but also on confidence of households and firms and hence on demand. Slower disinflation and higher rates would imply a longer period of subdued or even negative growth, so the length and depth of the recession is another source of uncertainty. In the Eurozone, the evolution of gas prices will be another important factor, given the concern that rebuilding inventories for the next winter could lead to significantly higher prices.

When gauging the list of uncertainties, it is also important to keep in mind the factors of resilience. In the US and the Eurozone, companies continue to struggle to fill vacancies. It is highly likely that, rather than laying off staff when demand weakens, they will hoard labour to have the necessary staffing when demand picks up. The accumulated 'excess savings' during the pandemic are another support factor, although they have been partly eroded already by high inflation. In Europe, the fiscal support in many countries to cushion the inflation shock and the implementation of the investment plans launched in response to the pandemic also bring resilience. Last and certainly not least, the energy transition implies a necessity to invest.

.

**William De Vijlder**
william.devijlder@bnpparibas.com