EUROZONE: THE DISINFLATION OF 2023, BETWEEN HOPE AND UNCERTAINTY

The latest ECB survey of professional forecasters (SPF) shows a downward revision of the growth outlook and an upward adjustment of the inflation forecast. For next year, the real question is not about the direction of inflation but about the speed and extent of its decline. Slower than expected progress could convince the ECB of the need for more rate hikes than currently priced by markets, implying a bigger output cost of bringing down inflation. Disinflation could indeed take longer than expected. Over the past two years, a variety of factors have led to an exceptionally elevated but also broad-based inflation. Not all shocks have occurred simultaneously and it often takes time for them to work their way through the system, from the producer to the wholesaler to the retailer. This creates an inertia in the inflation dynamics.

The latest ECB survey of professional forecasters (SPF) offers sobering reading. The growth outlook has been revised downwards -real GDP is expected to decline in the third and fourth quarter of this year and the first quarter of next year- and the inflation forecast has been revised upwards[1] . Moreover, despite the significant increases in the ECB policy rates and a worsening of financial conditions -higher sovereign bond yields, a widening of corporate bond spreads, the decline in equity markets, tighter loan conditions[2] -, uncertainty about the inflation outlook -based on the distribution of forecasts- continues to increase and the percentage of survey participants who expect inflation above 5% next year has jumped (chart 1).

2023 should nevertheless be a year of disinflation in the Eurozone on the back of favourable base effects, slower demand growth and an easing of supply bottlenecks. Concerning the supply side, survey-based price pressures -the average of the assessment of input prices and delivery times- are declining, which, given the historical relationship with core inflation, is a hopeful development (chart 2). The latest forecasts of the ECB, the IMF and private sector economists all anticipate lower inflation by the end of next year[3]. It thus seems that the real question is not about the direction of inflation -it should be down- but about the speed and extent of its decline. To put it differently: is there a risk that the inflation forecasts continue to be too optimistic as they have been for nearly two years and that further upward adjustments could be necessary? The answer matters for the interest rate as well as the growth outlook. A slower than expected decline could convince the ECB of the need for more rate hikes than currently priced by markets, implying a bigger output cost of bringing down inflation.

In trying to answer the question of the reliability of inflation forecasts, one can start by looking at the history of these projections. Chart 3 shows that the headline inflation forecast for the next 12 months is strongly influenced by current inflation, i.e. the pace of price increases over the previous 12 months. The forecasts are less volatile than observed inflation. In the important swings of the latter, energy price shocks play a big role. This also explains why the inflation forecast errors are highly correlated with the difference between headline and core inflation (chart 4)[4]. This implies that, assuming no new shocks to energy and food prices, the focus should be on core inflation. Unfortunately, the history of the SPF for core inflation only goes back to Q4 2016 so the period is too short for a proper assessment of the quality of forecasts when inflation is declining.

EUROZONE: AGGREGATE PROBABILITY DISTRIBUTION FOR EXPECTED INFLATION IN 2023

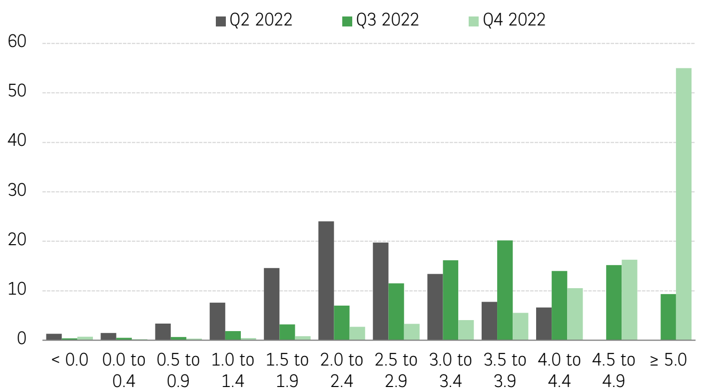

CHART 1 SOURCE: SOURCE: ECB, BNP PARIBAS

1. For 2023, for headline inflation to 5.8% (3.6%) and for core inflation to 3.9% (2.9%) (numbers between brackets show the forecasts from the Q3 survey).
2. The latest ECB bank lending survey, published on 25 October 2022 reported that "euro area banks indicated that they have further tightened their credit standards for loans or credit lines to enterprises in the third quarter." *There is also a "strong net tightening of credit standards for housing loans and a lesser, but still pronounced, net tightening for consumer credit in the third quarter of 2022."*
3. For Eurozone HICP, the IMF (World Economic Outlook, October 2022) expects 4.5% at the end of 2023. The Bloomberg economic consensus has a Q4 2023 forecast of 3.4% (data downloaded on 21 October 2022). Consensus Economics (October 2022) have a forecast of 3.0% for December next year and the September ECB staff projections expect inflation at 3.3% in Q4 2023.

4. This difference shows the direct effect of energy and food price shocks.

> Despite some hopeful signs, inflation risks remain clearly biased to the upside, meaning that next year's disinflation could be slower than currently expected.

There are however reasons to assume that disinflation could take longer than expected. Over the past two years, a variety of factors[5] have led to an exceptionally elevated but also broad-based inflation. Not all shocks have occurred simultaneously and it often takes time for them to work their way through the system, from the producer to the wholesaler to the retailer. This creates an inertia in the inflation dynamics, which is confirmed by recent contacts of the ECB with Eurozone companies (table).

To conclude, despite some hopeful developments -survey data showing an easing of price pressures, lower commodity prices-, risks remain clearly biased to the upside, meaning that disinflation could be slower than currently expected. Such a scenario would have important consequences in terms of interest rate developments, company profitability and households' purchasing power.

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EUROZONE: PMI MANUFACTURING VS INFLATION

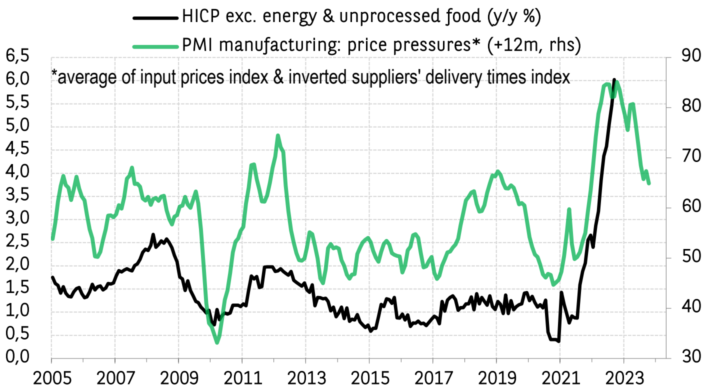

CHART 2

SOURCE: S&P GLOBAL, EUROSTAT, BNP PARIBAS

HICP: OBSERVED VERSUS ONE-YEAR-AHEAD FORECAST

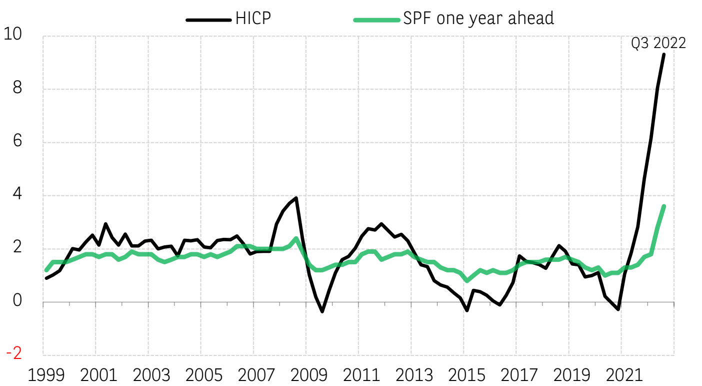

CHART 3

SOURCE: ECB, BNP PARIBAS

HEADLINE INFLATION FORECAST ERROR AND DIFFERENCE BETWEEN HEADLINE & CORE INFLATION

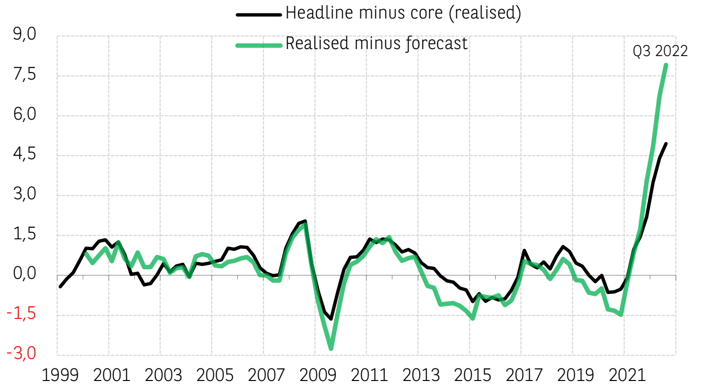

CHART 4

SOURCE: ECB, BNP PARIBAS

5. Demand in certain sectors has been very dynamic, which in combination with disruption on the supply side -staff, materials-, has created bottlenecks. Transportation costs have jumped due to disruption of global value chains. Energy, food and other commodity prices have seen huge price increases. The weak euro has led to higher import prices. High inflation and tight labour markets have given rise to a pick-up in wage growth.

COMMENTS FROM COMPANIES

"The prices of some raw materials and commodities had either stabilised or had been falling in recent months, although the effect of this on input costs was often either muted or more than offset by the weak euro exchange rate and the fact that past increases in costs (including for energy) were still in the process of being passed on by many suppliers."

"Prices for transport and logistics continued to increase overall; and while spot freight rates had fallen on some key shipping routes, this was hardly reflected in shipping costs, as these were mostly determined by long-term contracts."

"Concerning gas and electricity prices: "a substantial share of contacts said that the impact on their firm's cost base would be felt mainly, or only, in 2023 and beyond as long-term energy hedging and supply contracts expired."

"Most contacts still perceived strong cost pressures and continued to adjust their prices more frequently and by a greater order of magnitude than usual, with only a modest slowdown in the sequential rate of change currently anticipated in the next one or two quarters."

"Wage pressures continued to build."

"Among those who gave quantitative indications of their expectations for wage growth, a large majority expected increases of 4% or higher (and in many cases substantially higher) as likely to take effect in 2023."

SOURCE: MAIN FINDINGS FROM THE ECB'S RECENT CONTACTS WITH NON-FINANCIAL COMPANIES, ECB, ECONOMIC BULLETIN ISSUE 7/2022, 28 OCTOBER 2022.