EUROZONE

TO WHAT EXTENT SHOULD WE WORRY ABOUT THE RISK OF STAGFLATION?

The war in Ukraine compounds the ECB's task of balancing the fight against inflationary risks with the need to support growth. At the monetary policy meeting on 10 March, inflation was the predominant concern and the central bank announced that net securities purchases under the Asset Purchase Programme (APP) would probably end in Q3. This paves the way for the first increase in the key deposit rate, although the timing of the move is still highly uncertain. The inflationary shock is spreading while growth faces ever greater threats. Even so, pre-existing cyclical momentum, excess savings, investment needs and fiscal support measures should all help ease the risk of stagflation.

Consumer and business confidence surveys in the Eurozone deteriorated only mildly through February 2022 despite inflationary pressures and supply chain disruptions. Yet the outbreak of the war in Ukraine on 24 February has changed the situation. The impact on household confidence of surging inflation turned brutal, while the business climate has not been hit as hard so far according to confidence surveys[1]. In the months ahead, household confidence might not erode quite as fast while the decline in the business climate could accelerate.

It also remains to be seen to what extent the erosion of confidence and the inflationary shock will reduce growth. Looking solely at the impact of the oil shock, and assuming that a USD 10/barrel increase in oil prices slashes growth by 0.2-0.3 percentage points at a one-year horizon, then the USD 50 increase in the price of Brent crude oil between January 2021 and March 2022 could slash Eurozone growth by between 1 and 1.5 points in 2022. This is a substantial shock, and it comes on top of big increases in gas and electricity prices as well as numerous other commodity prices. The economy, however, is still in a post-Covid rebound phase with strong momentum (growth carry over was 1.9% in Q4 2021). Before the outbreak of the war, we were looking for growth of about 4% in 2022. Thanks to this very high starting point, we are able to conserve a positive post-war growth forecast, with a relatively high average annual growth rate of 2.8% based on our central scenario[2]. Yet this overall figure masks feeble quarterly growth rates, and we cannot rule out the possibility of several quarters of negative growth.

In this context, to what extent should we worry about the risk of stagflation? We are not there yet, if we consider that stagflation is a multiannual phenomenon that combines high unemployment with strong inflation (see chart 2). Although inflation is surging (7.5% y/y in March according to the Eurostat Flash estimate), the unemployment rate continues to fall (6.8% of the labour force in February). We also found it reassuring that business leaders' assessments of job prospects did not deteriorate much in March. In our baseline scenario, the war's impact on growth is offset by fiscal support measures, the mobilisation of excess savings inherited from the Covid-19 crisis, and investment needs (both pre-existing ones and new ones revealed by the conflict). We expect the shock to prove temporary (2023 growth is forecast at 2.7%), which should limit the upturn in the unemployment rate. In other words, higher inflation does not degenerate into stagflation. Yet there is a real risk given the downside risks to growth (it is worth monitoring the deterioration in households' assessments of unemployment prospects) and the upside risks to inflation. Although the latter remains mainly energy-related, the shock is spreading (core inflation was 3% y/y in March), and the level and timing of the inflation peak is still highly uncertain. Although there are still no signs of a price-wage loop, the environment is clearly more inflationary, which explains why the ECB tightened its tone at the 10 March meeting. Yet it was also based on growth forecasts that were probably overly optimistic (3.7% in 2022 and 2.8% in 2023 according to the ECB's central scenario). Although, on this basis, the ECB is preparing to halt net securities purchases as part of its Asset Purchasing Programme (APP) as of Q3 2022, this decision continues to be data-dependent. And although the halting of net securities purchases opens the door to an increase in the key deposit rate before the end of the year, the timing is still uncertain.

GROWTH & INFLATION

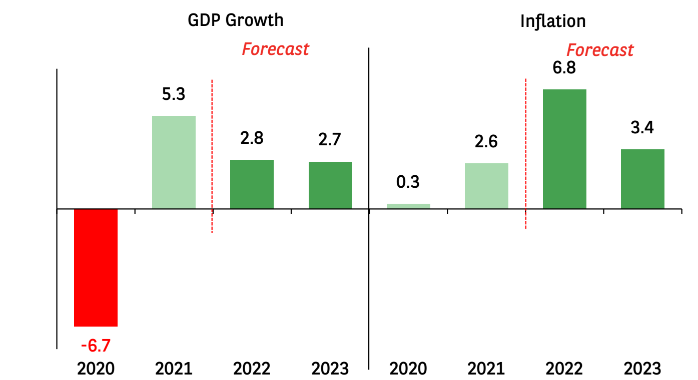

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A MEASURE OF STAGFLATION: THE MISERY INDEX (SUM OF THE UNEMPLOYMENT RATE AND INFLATION)

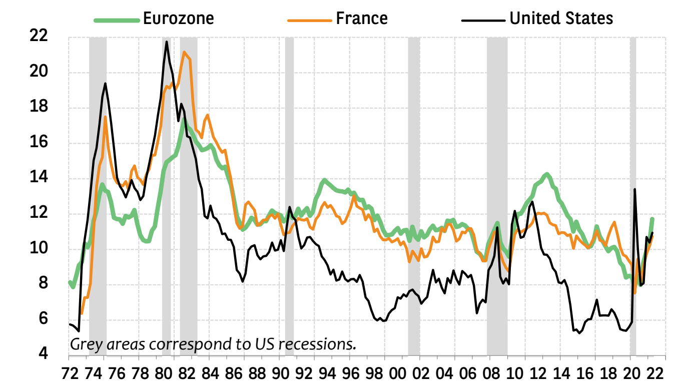

CHART 2 SOURCE: EUROSTAT, OECD, INSEE, BLS, BNP PARIBAS

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1 See Ecoweek n°22-14, Eurozone Barometer and editorial.
2 Our central scenario, which dates from 13 March, is based on the following working assumptions: no escalation in the Russian-Ukrainian conflict, but an extended period of uncertainty; sanctions will be maintained; oil is expected to peak at USD 150/barrel before easing to USD 120/barrel by the end of the year; and a partial disruption of oil and gas supplies.