AS INFLATION SOARS AND THE PANDEMIC RESURGES, GROWTH EASES

The resurgence of the Covid-19 pandemic and the emergence of the new Omicron variant make the ECB's task even harder. Although growth should hold at a high level, it is expected to ease, and this trend could worsen, at least in the short term. Meanwhile inflation continues to soar, while becoming more broadbased, and the risk in the coming months is on the upside. Faced with greater uncertainty, the ECB is arguing in favour of patience and constancy while saying it is ready to act in any direction. According to our scenario, which is somewhat optimistic in terms of growth and calls for persistent inflation, the ECB would end its Pandemic Emergency Purchase Programme (PEPP) in March 2022 and begin raising its key deposit rate in mid-2023.

Just how high will inflation climb? To what extent will growth ease under the combined impact of this inflationary surge, supply-side constraints (which continue to crescendo), a new wave of the pandemic compounded by the emergence of a new variant, and the simple normalisation of the growth rate?

Numerous headwinds are straining growth prospects in the Eurozone. Yet our scenario is still somewhat optimistic. Business sentiment was strong through November, which argues in our favour, and there is no lack of support factors to lift growth. The policy mix is still accommodative: although there is talk about reducing monetary and fiscal support, there is no question of eliminating them, much less tightening them. We estimate that NextGeneration EU, the European recovery package, will generate an additional 0.5 points of growth in 2022. Other support factors include the unblocking of excess household savings – at least partially – and a catching-up movement in the services sector as it returns to pre-pandemic levels. Lastly, there are major restocking and investment needs (to fund the energy and digital transitions, and to secure supply chains), and financing conditions are still advantageous. Our scenario also assumes that supply chain disruptions will begin to fade as of H2 2022.

After another quarter of vigorous growth (2.2% q/q in Q3), the Q4 outlook is much less attractive (0.4% q/q according to our forecasts). We nonetheless estimate that full-year growth will average 5% in 2021, the same as in our September forecast. Stronger supply chain disruptions and inflationary pressures have a negative impact on 2022, explaining the 1-percentage point downgrade of our growth forecast, to 4.2% (essentially due to weaker German growth). Yet the main characteristic of growth in 2022 is that it will hold well above its long-term trend. In 2023, growth is expected to remain strong (3% compared to our September forecast of 2.3%), as the abovementioned support factors continue to have an impact, albeit a smaller one. Downside risks predominate from a 6-month horizon, but they seem to balance out with upside risks in the longer term.

INFLATION IS NOT SO "TRANSITORY" ANYMORE?

Inflation continues to soar (4.9% y/y in November according to Eurostat flash estimate, near the all-time high of 5% in July 1991). Moreover, it is becoming more widespread. Core inflation is now high at 2.6%, and about 45% of its components are growing at a rate equal to or higher than 2% y/y. Most of this inflationary surge is still transitory, but that does not mean that we expect it to ease rapidly. Inflationary pressures due to supply-demand imbalances will take a while to dissipate. Moreover, conditions are propitious for slightly stronger wage inflation and for non-negligible indirect and second-round effects. This explains our rather high inflation outlook (average of 3.1% in 2022, after 2.5% in 2021, and 2% in 2023), which masks however an expected decline over

GROWTH AND INFLATION

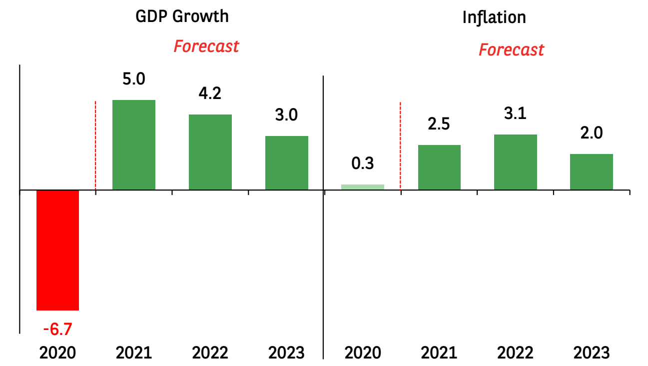

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

the course of 2022. According to ECB President Christine Lagarde, inflation probably peaked in November 2021. Our scenario makes the same assumption, but unlike the ECB, we expect inflation to hold just above the 2% target by year-end 2022 and not to drop below this threshold[1].

The resurgence of the pandemic coupled with the emergence of the new Omicron variant makes the ECB's task even harder. Greater uncertainty alone will have a negative impact on growth, even if the spread of the Omicron variant proves to be limited[2]. A significant deterioration in the health situation could ease inflation (by placing a greater strain on demand) as much as fuel it (by placing a greater strain on supply). We think the balance of risks leans towards a net inflationary effect.

Under this environment, the ECB's 16 December meeting takes on even greater importance. The ECB is expected to announce the end of the Pandemic Emergency Purchasing Programme (PEPP) according to the planned timeline, i.e., in March 2022, as well as the conditions under which the Asset Purchase Programme (APP) will pick up the slack (amount of monthly purchases, flexibility). The ECB is hardly likely to make any further commitments thereafter, arguing for the need for caution and consistency while insisting that it is standing by, ready to act, in a more or less accommodating manner. Based on our scenario of high growth and inflation, we expect the end of the TLTRO rebate at 50 bp below the deposit rate in June 2022, net purchases to be halted in Q1 2023, and the key deposit rate to be raised for the first time in June 2023 (+10 bp), followed by two more rate hikes of 15 bp each in September and December.

Hélène Baudchon
helene.baudchon@bnpparibas.com

1 Granted, we do not know the ECB's new inflation forecast, which will be released at the 16 December meeting. It seems highly likely, however, that it will be lower than our forecast, even though revised upwards from the September projections (2.2% in 2021, 1.7% in 2022 and 1.5% in 2023).
2 Yet the news concerning the health situation is not all bad: in addition to higher vaccination coverage rates, the arrival of the first treatments should help limit the number of severe cases and overloaded hospitals.