MORE INFLATION THAN GROWTH

Until May, Eurozone growth has been relatively resilient to the series of shocks that have swept the region, but its pace should slow more significantly in the months ahead. We cannot rule out the possibility of a recession, even though that is not our base case given the numerous sources of growth: post Covid-19 catch-up potential, surplus savings, investment needs and fiscal support measures. Our scenario appears to signal stagflation (inflation will be much higher than growth in 2022 and 2023), but with the big difference that the unemployment rate is not expected to rise much. The ECB is preparing to begin raising its key policy rates to counter the inflationary shock. We are looking for a cumulative 250bp increase in the deposit rate, bringing it to 2% by fall 2023.

According to our scenario, the Eurozone economic environment is getting worse first before getting better. On the one hand inflation continues to soar and supply chain disruptions persist, aggravated by the war in Ukraine and China's zero-Covid strategy, and on the other hand, the stock markets collapsed in May-June and long-term rates rose rapidly against the backdrop of an accelerated, effective and widely expected normalisation of monetary policies. As necessary as it may be, this monetary normalisation is nonetheless stirring things up.

Let's look more closely at inflation, the core problem. It continues to rise and gain in strength. Inflation hit 8.1% year-on-year in May (0.7 points higher than in April) and still shows no signs of peaking yet. Inflation remains mainly driven by the energy component (for a small half), but core inflation is rising too (3.8% y/y, 0.3 points higher than in April). The relative contribution of manufactured goods prices has been rising for the past year, to 44%, while that of services prices has been falling, to 56%. Core inflation explains nearly a third of headline inflation (this share has been more or less stable for the past year) while the food component now accounts for 20%. Over the past year, the relative contribution of the food component has a little more than doubled, while the one of the energy component has declined by 10 points. Another indicator of diffusion is that in May, as in April, about 70% of the components of the HICP and core inflation index had increased by more than 2% y/y. Alternative measures of core inflation (super core, median and the trimmed mean) range from 4% to 7% y/y, which also shows the extent of the problem. Unsurprisingly, inflation expectations are also rising, albeit moderately for the moment.

Yet the economic news is not all bad. The business climate in industry, services and construction has not deteriorated much up through May, the most recent data point. Business climate indexes are holding at high levels, which is consistent with strong growth. The retail business climate and consumer confidence, which are more exposed to the inflationary shock, declined sharply in March and April, but this trend did not get any worse in May. The signals from the job market are still reassuring: the unemployment rate is low and stable, hiring difficulties remain very high as well as hiring intentions, and household fears of unemployment stay low. It is also worth reiterating that there are major sources of growth: post Covid-19 catch-up effect, surplus savings, investment needs and fiscal support measures.

Even so, growth is expected to slow down more sharply in the months ahead. After +0.6% q/q in Q1 2022 (a figure inflated by the 0.4-point contribution of the surge in Irish GDP, which rose nearly 11% q/q), we expect Eurozone GDP to contract by -0.2% q/q in Q2, followed by barely positive growth in Q3 (+0.1% q/q) before rebounding more strongly in Q4 (+0.5% q/q), buoyed by the above-mentioned support factors and the expected easing of the inflationary shock and supply chain disruptions. This rebound should extend into 2023. In 2022, we are forecasting average annual growth of 2.5%, which might seem high (thanks to the carry-over of 2.5% in Q1 2022) but is actually low (considering the 1% y/y growth forecast for Q4 2022).

GROWTH & INFLATION

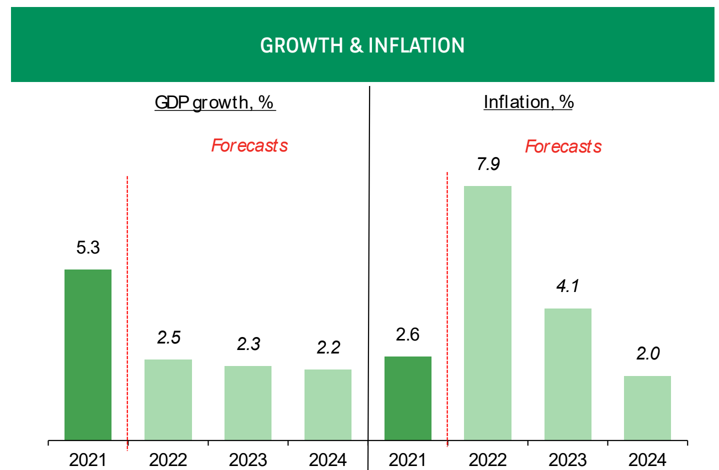

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Current forecasts of average annual growth (not only ours, but those of other international institutions) also stand out for what seems like stagflation: inflation will be much higher than real growth in 2022 and 2023, before normalising somewhat as of 2024. The difference with a scenario of true stagflation, however, lies in the unemployment rate, which is not expected to rise very much.

Under this environment, the ECB confirmed that on 1 July it would end its net asset purchases via the Asset Purchase Programme (APP). The central bank is also preparing to begin raising its key rates, with Ms Lagarde announcing a 25bp increase in the deposit rate on 21 July. We cannot exclude a bigger move. We are then looking for two 50bp rate hikes in September and October, followed by three 25bp rate hikes in December, February and March. Two final 25bp rate increases in June and September 2023 would complete this cycle, bringing the deposit rate to 2%, within our estimated range for the neutral rate (1.5-2.5% for the nominal rate; -0.5% to +0.5% for the real rate). At this level, the ECB's monetary policy would not be restrictive. A new tool is also being prepared to combat the unwarranted widening of spreads within the Eurozone, in order not to interfere with the normalisation and smooth transmission of monetary policy.

Our scenario, like the ECB's, calls for a soft landing of the economy, with growth slowing down (under the impact of the inflationary shock and orchestrated via monetary normalisation) in a controlled manner (thanks to the support factors mentioned above), albeit sufficiently to ease inflation. Lower inflation, in turn, should help ease the downward pressure on growth. We see the current inflationary shock as intrinsically disinflationary and not a source of stagflation.

Hélène Baudchon
helene.baudchon@bnpparibas.com