EUROZONE

A STRONGER RECOVERY, HIGHER INFLATION AND AN ACCOMMODATING ECB

The Eurozone economy is bouncing back. From a macroeconomic perspective, the region is closing the gap on the losses accumulated since spring 2020 more quickly than expected just a few months ago. Unless a new wave of the pandemic breaks out due to the spread of Covid-19 variants, Eurozone GDP should return to pre-crisis levels by the end of the year. Accelerated vaccination campaigns and the gradual lifting of health restrictions are reducing uncertainty and boosting the confidence of economic agents. Consumers, who have adapted to restrictive health measures, are playing a key role. Despite these favourable dynamics, public policies are remaining cautious. From a monetary perspective, the European Central Bank recently expressed some optimism concerning the Eurozone's capacity to rebound, although for the moment it is refusing to begin tightening monetary policy. As to fiscal policy, investors welcomed the European Commission's first bond issue to finance the Next Generation EU recovery plan.

A STRONGER-THAN-EXPECTED ECONOMIC RECOVERY

At a time marked by the gradual lifting of health restrictions, accelerating vaccination campaigns in the member states, and the continuation of accommodating economic policies, the Eurozone's economic situation is improving more rapidly than expected just a few months ago. After the losses accumulated throughout the long months of the pandemic, the economic recovery is now well underway and has spread to all segments of the economy. From a cyclical perspective, the situation in the manufacturing sector has improved significantly since April 2020, and manufacturing PMI reached an all-time high of 63.1 in June 2021. Although it has declined slightly, the "new export orders" component is still holding at a high level compared to the long-term average. Hard data confirm these survey results: industrial production increased massively in April for the second consecutive month, although a large part is admittedly due to a favourable base effect (+39.3% in April 2021, after +11.5% in March and -30% in April 2020).

In the tradeable services sector, where it is reasonable to expect activity to rebound more belatedly, the services PMI picked up again. After 50.5 in April and 55.2 in May, it rose to 58 in June, the highest level since early 2018. The lifting of health restrictions in most of the Eurozone member states, combined with the acceleration of vaccination campaigns, is providing economic agents with brighter prospects. The European Commission's business sentiment index continued to rise to 114.5 in May, the highest level since January 2018, and it is holding comfortably above its long-term average. Eurozone households are smiling again, and the consumer confidence index is now well above pre-pandemic levels. This favourable momentum is reflected in retail sales, which accelerated strongly in April. All of this augurs well for an ongoing catching-up movement in the Eurozone, especially since consumers have accumulated a considerable volume of savings over the past year.

All in all, the Eurozone's quarterly GDP growth will follow a relatively jagged profile in 2021, and GDP should return to pre-pandemic levels by the end of the year (Chart 2). GDP accelerated sharply in Q2 and again in Q3, driven by the rebound in household consumption. In Q4, the Eurozone economy is automatically expected to slow. Thanks to a strong carry-over growth effect, annual GDP growth will rise in 2022 compared to 2021, even though quarterly momentum is slowing. GDP growth is estimated at 4.8% in 2021 and 5.2% in 2022.

GROWTH AND INFLATION (%)

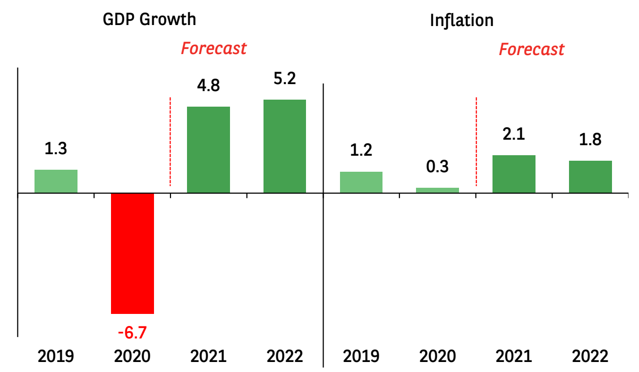

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP OF EUROZONE MEMBER STATES (100= Q4 2019)

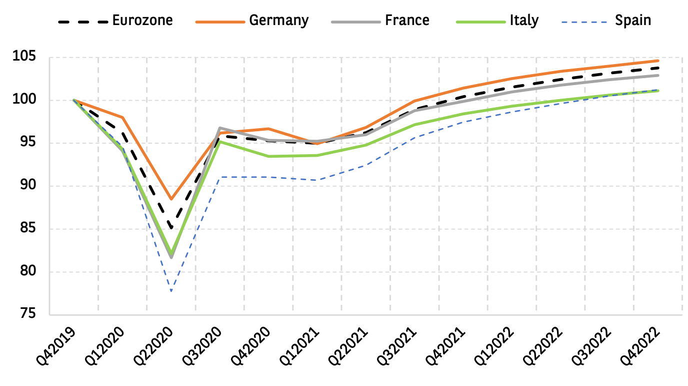

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS GLOBAL MARKETS

RISING INFLATION: THE ECB BIDES ITS TIME

With the rebound in global demand, consumer prices have accelerated rather sharply in recent months, and these pricing dynamics are expected to extend into H2 2021. Yet rising inflation is mainly due to temporary factors (VAT movements in Germany, higher commodity prices, change in the weighting of the various components of HICP)[1].

According to our latest scenario, this inflationary surge is unlikely to last. This is also the ECB's point of view[2]. The European Central Bank expects inflation to peak this year. According to its latest macroeconomic projections, headline inflation will rise to 1.9% in 2021 before declining to 1.5% in 2022 and then to 1.4% in 2023, which is low with regard to the central bank's medium-term target of 2%. The ECB is counting on a slight upturn in the core inflation (which does not take into account products with the most volatile prices), which should continue to trend upwards to 1.4% in 2023. This is much faster than the average pace in recent years, which was close to 1%. The ECB does not expect a surge in inflationary dynamics, which will be curbed in part by the persistent imbalances in the labour market and by wage growth, which remains subdued (Chart 4).

Although the central bank is expressing some caution with regard to pricing trends, it is more optimistic when it comes to the Eurozone economy's capacity to recover. At its monetary policy meeting on Thursday, 10 June, the ECB nonetheless chose to maintain a wait-and-see approach and is not rushing to tighten its monetary policy. It will continue to make net securities purchases as part of the Pandemic Emergency Purchase Programme (PEPP), but at a significantly faster pace than at the beginning of the year. We expect PEPP to end in March 2022, since the economic emergency should be over by then. To avoid a sharp drop in liquidity, and considering the inflation gap, we expect securities purchases to increase under the existing Assets Purchases Programme (APP). Monthly net purchases could rise from EUR 20 bn today to EUR 40 bn or more. In any case, the ECB will probably maintain a flexible approach to its securities purchasing policy, in order to avoid as much as possible a tightening of financing conditions in the Eurozone, even after the crisis is over.

The Governing Council of the ECB seems to have postponed the more difficult discussions until the next meeting in September. By then, it could decide on whether to continue the PEPP, which as always will depend on the state of the Eurozone economy. Decisions will also be made under the framework of its strategy review. The first conclusions could emerge by the end of the year, which is no small matter. From a monetary perspective, the ECB could follow the Fed's lead and introduce a structurally accommodating bias to its monetary policy. It might also decide to pursue an average inflation target, which means that inflation would be allowed to exceed 2% for a certain time.

National fiscal policies need to accompany the ECB's monetary policy to avoid withdrawing support too abruptly and without differentiating between sectors. At the European level, the Next Generation EU recovery plan could have a favourable impact on the effectiveness of public spending, especially in the peripheral countries of the Eurozone. The European Commission's first issue of EUR 20 bn in bonds to finance this recovery plan was a success.

Completed on 28 June 2021

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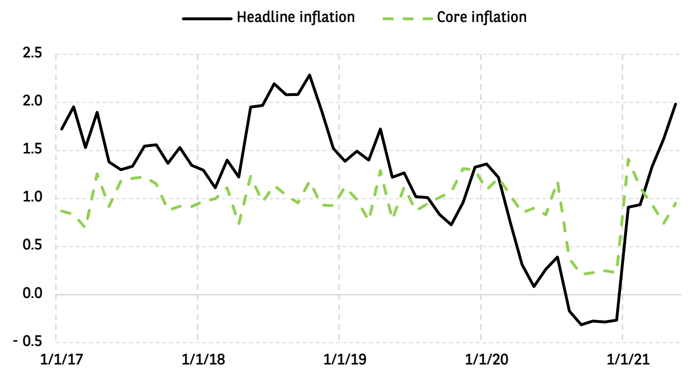
HEADLINE AND CORE INFLATION IN THE EUROZONE (%)



GRAPHIQUE 3 SOURCE: EUROSTAT

NOMINAL WAGE GROWTH IN THE EUROZONE (%)

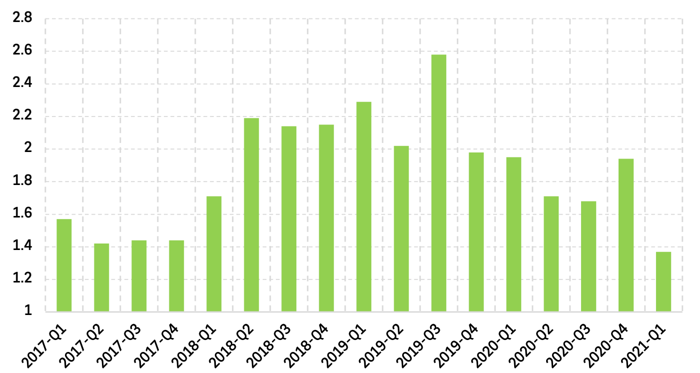


CHART 4 SOURCE: EUROSTAT

1 L. Boisset and G. Derrien, *Eurozone: the upturn in inflation could be short-lived*, BNP Paribas, April 2021
2 Macroeconomic projections for the Eurozone, ECB, June 2021