EUROZONE: WILL THE TERMINAL RATE BE REACHED THIS SUMMER?

The eurozone entered a technical recession in Q1 2023, with Eurostat having revised lower its estimate of quarterly GDP growth for Q1 from +0.1% to -0.1%, the same contraction as in Q4 2022. These results do not profoundly change our assessment for 2023: weak or slightly negative economic activity, quarter-on-quarter, although growth for 2023 as a whole should be more positive thanks to the favourable carry-over growth effect. Our current forecasts are based on a terminal refinancing rate of 4.5%, which would be reached at the monetary policy meeting on 14 September. Nevertheless, the scenario of harsher tightening cannot be completely ruled out, given the ongoing inflationary momentum and still high inflation generalisation indices.

Energy prices (natural gas, oil) continued to fall in the spring, fuelling the drop in general inflation in the eurozone. Nevertheless, the disinflation process will be slow[1], with inflation not expected to fall back to its 2% target level before 2025, according to our forecasts. Although food products remain by far the main contributor to the rise in the consumer price index, a proportion of inflation is also centred on services (accommodation and food services, recreation and culture, transport services) and fuelled by wages. Base salaries in the eurozone rose 4.3% year-on-year in Q1, according to the ECB's indicator of negotiated wages. This is the biggest increase since the creation of the monetary union. The rise in wages was still below the pace of inflation in the eurozone, but the two curves should cross over during Q3, marking the return to positive territory of the increase in real wages.

In 2022, monetary union benefited from several favourable levers -significant household savings after the health crisis, business recovery with the gradual resorption of disruptions to global production chains, high level of budgetary support- to cushion the inflationary shock and the interest rate shock. These supports will not be as strong in 2023. Furthermore, while supply constraints on components and capital goods are expected to fade (they remained significant in Q1 according to the European Commission survey on limits to production), labour shortages are expected to persist for longer under the effect of the unprecedented tightening of the labour market. The unemployment rate reached a new low of 6.5% in April.

However, we are seeing more signs of a bearish environment. The drop in industrial activity in the eurozone was contained until April, but the manufacturing PMI deteriorated month after month (44.8 in May), while new manufacturing orders in Germany this spring plunged to levels not seen since the 2020 health crisis. In addition, retail sales of food products have been declining significantly in real terms for over a year. Business in services remained more dynamic, with a PMI index at 55.1 in May. While in the short term, the dynamics between the manufacturing sector and services seem to be diverging, in the long term there will be a convergence, probably due to a drop in business in services. In Q3, activity in this sector should be supported by the tourist season, which is once again looking strong. Nevertheless, the continued monetary tightening should ultimately have more widespread effects on the economy.

For the ECB, the correct adjustment of its policy rate is proving even more difficult, given the significant divergences in inflation rates between eurozone countries, both for the headline measure and for underlying inflation.

GROWTH & INFLATION

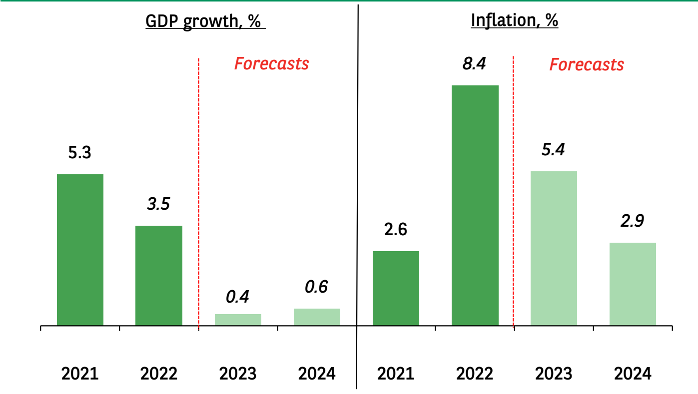

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Most economies in the eastern part of the monetary union posted core inflation close to 10% (Croatia) or above 10% (Baltic countries, Slovakia) in May 2023, while the rise remained significant in the Netherlands (8.2%) and Austria (7.9%). Conversely, inflation fell below 4% in Spain (3.8% in May). However, the decisions taken elsewhere by central bankers in recent weeks (Australia, Canada) illustrate the monetary authorities' determination to curb inflation, even if this means doing so more aggressively than expected by markets. The ECB seems to be heading in this direction. In early June, Isabel Schnabel, a Member of the Executive Board of the European Central Bank, considered a «hawk», reiterated that in the fight against inflation, *"given the high uncertainty about the persistence of inflation, the costs of doing too little continue to be greater than the costs of doing too much*[2]*"*.

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1 See BNP Paribas, Inflation tracker, June 2023
2 Interview in the De Tijd newspaper, 7 June 2023. https://www.ecb.europa.eu/press/inter/date/2023/html/ecb.in230607~3fc7acf294.fr.html