Article | 2 March 2023

Eurozone: Better than expected doesn't mean good

Lower energy prices have boosted both business and consumer confidence. However, the better growth outlook will slow the decline in core inflation, pushing the ECB to act more forcefully. A terminal deposit rate of at least 3.50% now seems likely. Consequently, the economy will slow down in 2H and 2024's growth is likely to be weaker than 2023's expansion

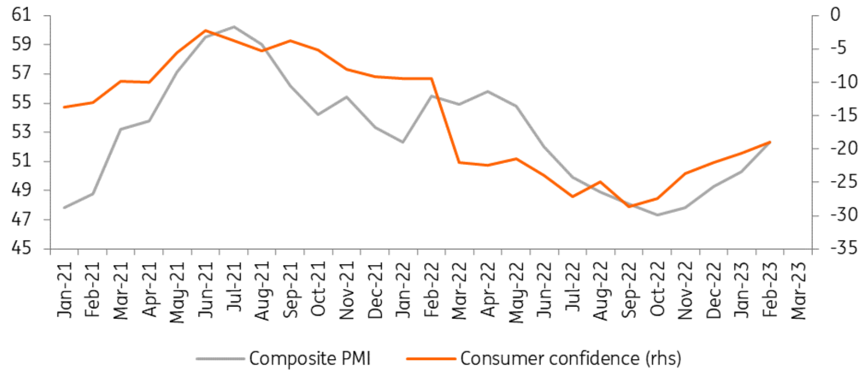
Source: Shutterstock

Black or red zero

After the recent downward revision of German GDP growth figures for the fourth quarter of 2022 to -0.4% quarter-on-quarter (which might also lead to a small negative figure for the eurozone) the jury is still out on whether a winter (technical) recession has now been avoided after all. Not that it matters much, because we are basically talking about a black or a red zero. What is more important is whether the underlying momentum is improving or not. The good news is that the PMI composite indicator rose for the fourth consecutive month in February on the back of improving supply chains, rising demand and a reduction of order backlogs.

While the European Commission's economic sentiment indicator took a breather in February after three months of growing confidence, the picture still reflects a healing consumer. The assessment of activity over the past three months in services and in the retail sector points to growing consumption, after a weak fourth quarter. That said, it is not unlikely that some of the demand will be satisfied out of currently bloated inventories. The bottom line is that growth in the first quarter is still likely to hover around 0%, but also that the economy has gradually entered recovery territory.

Eurozone confidence is improving



Source: Refinitiv Datastream

Shaky recovery

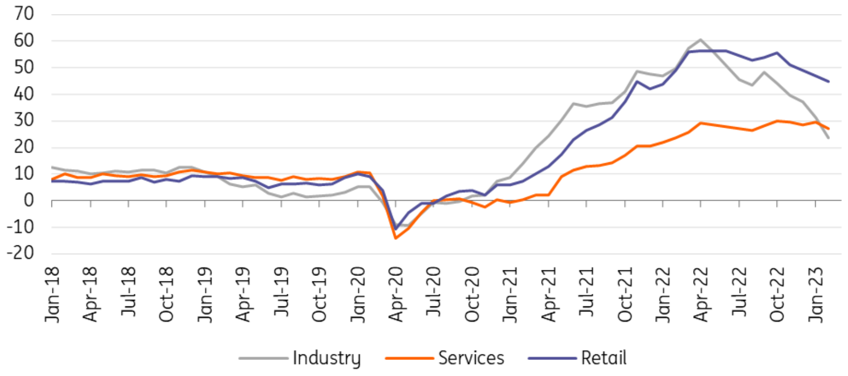
Even though falling gas prices are providing the economy with some oxygen, it is too early for optimism. Energy prices are unlikely to remain at the current low level for the whole of the year, although we now believe that any increase will remain limited. Fiscal policy, which is still a tailwind, is likely to get less stimulative in the second half of the year. And of course, the ECB's monetary tightening will eventually act as a brake on growth. According to its own models, the negative impact on real GDP growth of the current monetary tightening is estimated to be around 1.5 percentage points on average over the three years from 2022 to 2024, with the biggest impact in 2023 and 2024.

After a stronger growth figure in the second quarter, we see the expansion softening again in the second half of the year. For the whole of the year, this results in a small upward revision in our growth forecast to 0.8%. However, with the biggest impact of fiscal and (additional) monetary tightening felt next year, we have downgraded 2024 GDP growth to only 0.7%.

Stubborn inflation

Headline inflation is now on a downward path on the back of the year-on-year decline in energy prices. However, core inflation unexpectedly climbed to 5.6% in February, the highest level since the start of the Monetary Union. That said, looking at price expectations in the business surveys, it seems as if we're also close to the peak in core inflation, though it might still take several months before a clear downturn sets in. The fact that consumption is picking up is certainly not helping to get inflation down rapidly. On the back of falling energy price inflation, we have decreased our headline inflation estimate to 5.5% for 2023, while for 2024 we now anticipate 2.6% headline inflation.

Price expectations are not coming down as fast in all sectors



Source: Refinitiv Datastream

A more hawkish ECB

The ECB already signalled another 50 basis point rate hike in March, but it now looks all but certain that the tightening cycle will go further after that. With a strong downturn averted, core inflation rather sticky, and medium-term consumer inflation expectations back up to 3%, the ECB is probably not done yet at a deposit rate of 3.0%. Board member Isabel Schnabel even described an anticipated 3.50% terminal rate by markets as being "priced for perfection". In that regard, a higher terminal rate could be envisaged. However, for the time being, we stick with two additional 25bp rate hikes in the second quarter and the deposit rate remaining at that level until the fourth quarter of 2024. With short-term rates remaining high for longer, we have also raised our bond yield forecast, with the 10yr Bund hovering around 2.50% in the first half of the year, before a modest rally brings it back to 2.25% by the end of 2023.

Author

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com