

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



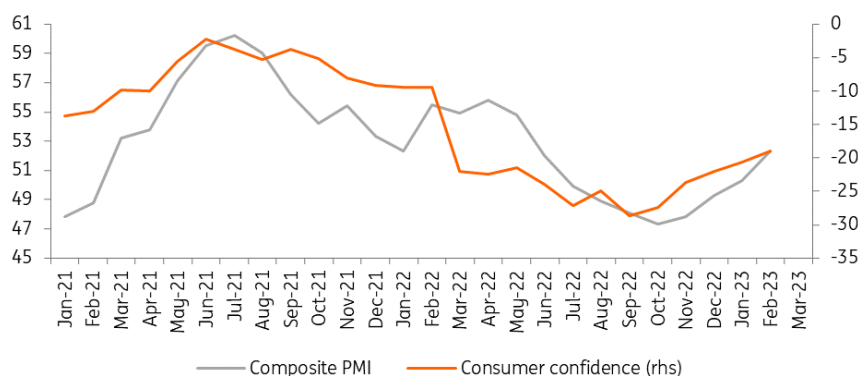
Source: Shutterstock

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

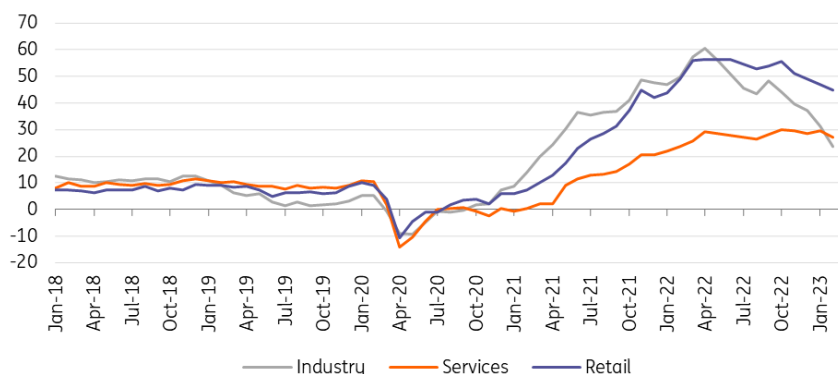
Even though falling gas prices are providing the economy with some oxygen, it is too early for optimism. Energy prices are unlikely to remain at the current low level for the whole of the year, although we now believe that any increase will remain limited. Fiscal policy, which is still a tailwind, is 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

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom

this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.