Eurozone: ECB hawks are coming to the fore

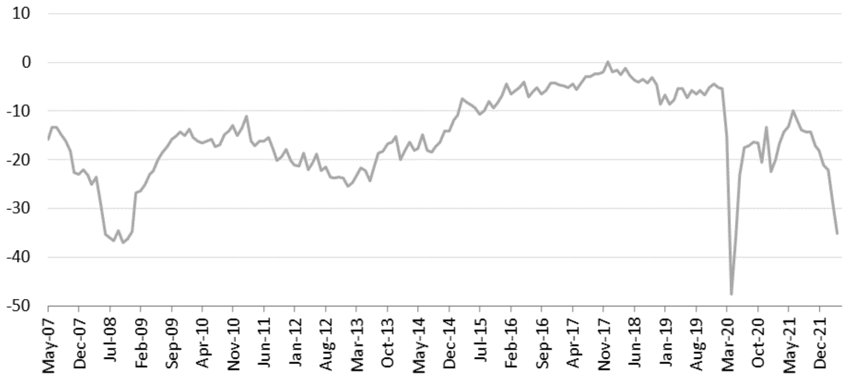
The eurozone still managed to grow in the first quarter of 2022, but a significant slowdown looks likely on the back of the war in Ukraine. While inflation is likely to peak over the summer months, the European Central Bank seems prepared to normalise policy more rapidly to prevent a 'de-anchoring' of inflation expectations

We think eurozone GDP will contract in the second quarter

Surprise growth in the first quarter...

While the US saw a contraction in the first quarter, eurozone GDP still grew by 0.2% quarter-on-quarter. However, we doubt that the second quarter will show positive growth again. Demand is clearly weakening. On the back of the war in Ukraine and dwindling purchasing power, consumer confidence crashed in March and remained around the same low level in April. The component regarding major consumption purchases fell back in April to the lowest level since the lockdowns in 2020. Business confidence held up better, but also seems to have peaked. With the Omicron lockdowns in China intensifying in April, supply-side issues are likely to hamper eurozone industrial production in the coming months. A recent Ifo survey actually showed that 46% of German companies receive significant inputs from China.

Survey on 'major purchases at present' shows that consumption is tanking

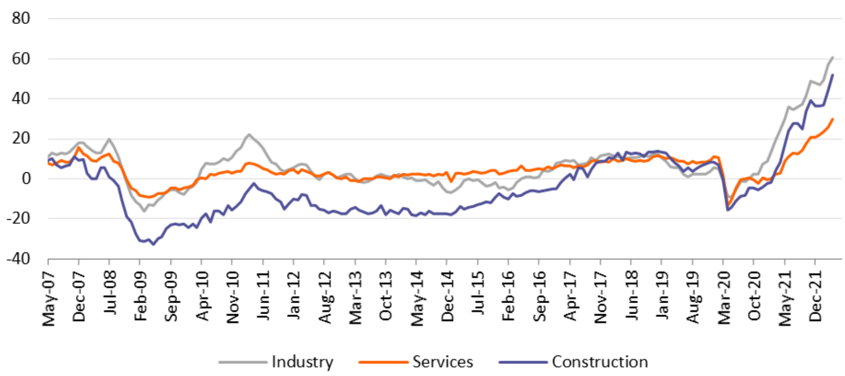


Source: Refinitiv Datastream

…but the second quarter might see a contraction

We, therefore, think that eurozone GDP will contract in the second quarter. A recovery thereafter is likely to remain subdued as some of the headwinds remain. We don't expect a significant decrease in energy prices and that will continue to exert downward pressure on purchasing power as natural gas and electricity contracts for European consumers are only gradually adapted to this higher price regime. Things might even get worse. Europe could decide on an energy embargo against Russia, or Vladimir Putin might turn off the gas taps himself if he feels Europe is getting too involved in the war in Ukraine. That of course would be a very adverse shock to the eurozone economy. While simulations are all over the place, it is safe to assume that this would cost the eurozone a few percentage points of GDP, thereby provoking a recession. This is not our base case, however. For the time being, we are looking at 2.2% GDP growth in 2022 and 1.9% in 2023.

Selling price expectations reach unprecedented levels



Source: Refinitiv Datastream

Selling prices to increase further

We realise that this is starting to resemble Groundhog Day, but we are forced to revise our inflation forecast up again for the eighth month in a row. Barring an embargo on Russian energy, energy inflation seems to be close to a peak. But food inflation is likely to hover around 6% in the second half of the year and there is still a lot of inflationary pressure in the pipeline, as recently indicated by another record high in businesses' selling price expectations. On top of that, underlying inflation is now also picking up more rapidly than expected (at 3.5% in April), with services benefiting from the full reopening of the economy to raise prices. Consequently, any decline in inflation is going to be very gradual and it could take until the late summer before headline inflation numbers actually come down. Fourth quarter inflation is still likely to be above 5%, with the average for the year now forecast at 6.4%.

No brainer

Notwithstanding the more uncertain growth outlook, the ECB has turned a lot more hawkish, particularly since the long-term inflation forecast in the Survey of Professional Forecasters is now also (slightly) above 2%. Pierre Wunsch, a member of the Governor Council, called a deposit rate at 0% this year a "no brainer". We agree and now expect the ECB to hike rates in July, September and at the turn of the year, even if weaker-than-expected data alters the timing. After that, we might be in for a long pause as a strengthening euro and a slowing US economy are likely to take away some of the upward inflation pressures.

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