Eurozone economy helped by another mild winter

Another mild winter pushing down natural gas prices is helping the eurozone economy to come out of the doldrums, though 2024 growth is likely to remain subdued. With sticky services inflation and strong wage growth, the European Central Bank is in no hurry to cut interest rates – a fact that financial markets are now also acknowledging

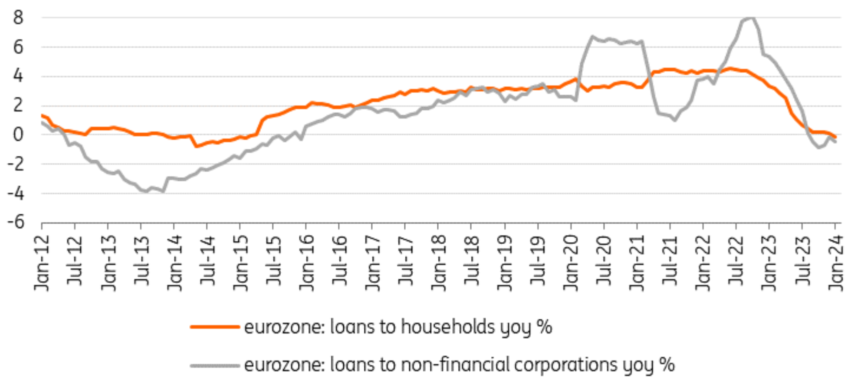
Rome, Italy: mild winter in the historical Villa Pamphili urban park

Lower natural gas prices

Another mild winter and well-filled gas inventories have pushed down natural gas prices in Europe to the lowest level since the second quarter of 2021. That is not only helping to bring inflation further down, but also constitutes a tailwind for the eurozone economy. Sentiment indicators continue to climb higher, albeit from depressed levels. As such, the PMI composite indicator rose to an eight-month high in February, though remains below the 50 boom-or-bust level. The German Ifo indicator also made minor progress in February. That said, weakness in the German economy continues to weigh on overall eurozone growth.

The divergence between manufacturing and services remains in place, with manufacturing still digesting the inventory overhang while services activity accelerates on the back of decent consumer demand. According to the PMI survey, eurozone employment increased for the second month in a row in February, though this is entirely due to stronger hiring in the services sector. That said, the inventory correction should be over by the summer – heralding a recovery in manufacturing – while the negative impact of higher interest rates on construction should gradually peter out. Indeed, January's lending figures for the eurozone show that loan growth is still weak, but the downturn seems to be behind us, with month-on-month figures even showing some modest growth.

Impact of higher interest rates on loan growth is petering out

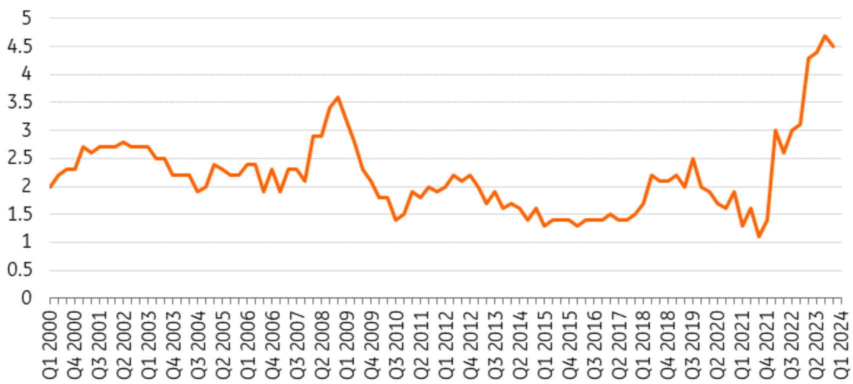


Source: Source: LSEG Datastream

Revamped Stability and Growth Pact could bring tighter fiscal policy in 2025

While first quarter growth is still likely to hover around 0%, we anticipate a gradual improvement from the second quarter onwards. That said, a temporary downturn in the US later this year might jeopardise the strength of the eurozone's recovery. We're therefore sticking to our 0.4% growth forecast for 2024. We anticipate growth to pick up in 2025, but we don't expect above potential growth. The revamped Stability and Growth Pact for 2025 actually implies that, after a year without much budget consolidation (except for Germany), a number of member states will be forced to conduct a more restrictive budgetary policy next year. This will limit the growth acceleration to 1.4% GDP in 2025.

Wage growth is decelerating too slowly



Source: Source: LSEG Datastream

Wage growth remains too high for the ECB

Low natural gas prices, and the impact on electricity prices, are good news for headline inflation.

However, price developments in the services sector remain worrying. According to the PMI survey, services prices rose at the sharpest rate for nine months in February, with the rate of inflation having accelerated for four months in a row. Negotiated wage increases in the eurozone decelerated in the fourth quarter to 4.5% year-on-year from 4.7% in the third quarter.

That deceleration likely remains too timid for the European Central Bank, also taking into account that productivity growth has been negative in the second half of 2023. The bottom line is that the ECB – being confronted with a bottoming out of the economy and inflation remaining too high – can afford to remain in wait-and-see mode. New wage figures will only be available by May, and we therefore don't expect any rate cut before June. At the same time, we believe the ECB will ease very slowly at a pace of 25bp each quarter, bringing the repo rate to 2.5% by the middle of next year. Interestingly, the market has gradually moved in our direction and is now also pencilling in less aggressive rate cuts than seen previously.

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