The eurozone's muddling through at best

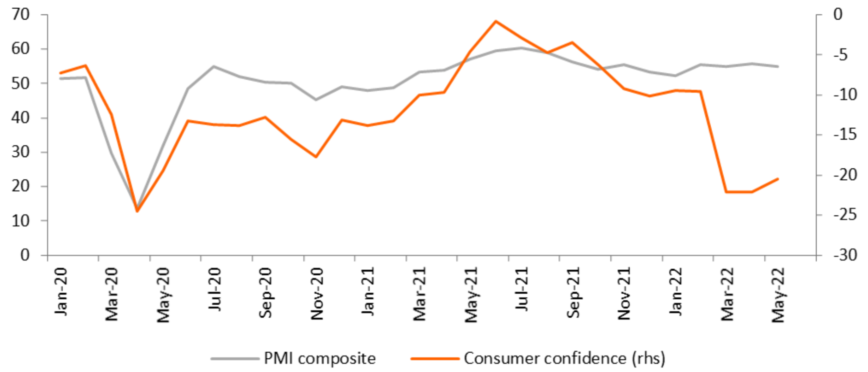
Persistent headwinds are pushing the eurozone into a 'muddling through' scenario, and there is a high probability that the region will see one quarter of negative growth this year. But sticky inflation and higher inflation expectations will force the European Central Bank to abandon negative interest rates in the third quarter

Muddling through? President of EU Commission Ursula von der Leyen and European Council President Charles Michel at a summit this week in Brussels

Farewell to negative interest rates

In a blog on the ECB's website, President Christine Lagarde brought forward the growing consensus that has been building within the governing council, namely that stickier-than-expected inflation requires the quick removal of non-conventional policy measures. A first rate hike in July looks like a near certainty and a 50bp increase cannot be excluded, especially if core inflation comes in higher than expected in the run-up to the July meeting. In any case, negative rates will have disappeared come September. It now seems that the ECB wants to seize the window of opportunity to normalise monetary policy. This requires policymakers to walk a fine line between the rising inflation expectations and economic headwinds.

Sentiment divergence between consumers and businesses



Source: Refinitiv Datastream

Mixed feelings

The first quarter showed an upwardly revised 0.3% quarter-on-quarter growth rate, but the second quarter looks more of a conundrum. There is no hard data yet and the sentiment data has been rather inconsistent. Since the start of the war in Ukraine, consumer confidence has dropped to recessionary levels, with the May reading showing hardly any improvement. However, business confidence figures have held up better while still declining.

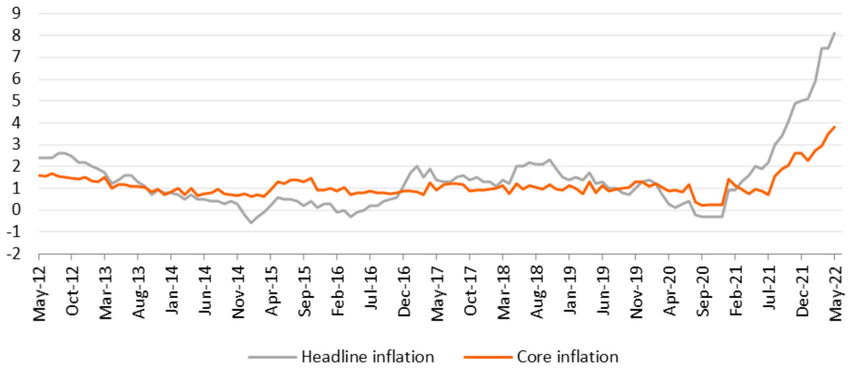
The flash eurozone PMI composite index came in at 54.9, firmly above the boom-or-bust 50 level. This is largely on the back of a strong services sector, which seems to be benefiting from some post-pandemic catch-up demand. Indeed, holiday reservations are back or even above pre-pandemic levels. In the manufacturing sector, the deceleration is more obvious on the back of renewed supply chain problems, higher input prices, and falling orders.

Not exactly the roaring twenties

There is no clear weakening yet in the labour market, but wages, although rising a bit more rapidly now, are definitely not keeping pace with inflation. At the same time, oil prices are climbing on the back of a (partial) European boycott of Russian oil, further sapping households' purchasing power. As such, we don't think that consumption will be a strong growth driver in the coming quarters. And businesses might also become more cautious in their investment plans.

That said, there still seems to be a willingness among governments to support the weakest households with fiscal measures. And as the European Commission has proposed extending the escape clause for the Stability and Growth Pact into 2023, not a lot of fiscal tightening should be expected for the time being. We still believe the second or the third quarter of this year might see negative growth. Thereafter, we think the growth pattern will be pretty much in 'muddling-through' mode. That should still result in 2.3% GDP growth in 2022 and 1.6% in 2023. Not a recession, but not exactly the roaring twenties either. And downside risk prevails.

Both headline and core inflation continue to surpass expectations



Source: Refinitiv Datastream

Higher inflation expectations

Barring a strong increase in natural gas prices amid fewer imports (or a stoppage of supply) from Russia, inflation is probably close to its peak. In May, headline inflation rose to 8.1%, with core inflation at 3.8%. We expect the decrease to be very gradual and it might take until the second half of 2023 before headline inflation falls back below 2%. At the same time, longer-term consumer inflation expectations have now seen an upward shift to 3% in the most recent survey, which explains why the ECB wants to get rates out of negative territory pretty soon.

In an interview in Cinco Días, Philip Lane, the ECB's chief economist, made it very clear that this should be a done deal by September. What happens afterwards will be data-dependent. We don't think a wage-price spiral will develop, as in the most recent wage agreements the increase foreseen for 2023 is only 2.4%, below the 3% the ECB considers consistent with its 2% inflation objective. That said, we can imagine that the ECB will want to get a bit closer to the elusive "neutral interest rate". Therefore we think the deposit rate will be raised to 0.25% by year-end, moving to 0.50% in 1Q 2023. Thereafter, a long period of 'wait-and-see' might follow.

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