Article | 8 December 2022

Our 3 calls for the eurozone

After a mild winter recession, the eurozone is likely to see a very subdued recovery, while inflation is bound to end in 2023 above 3%. Meanwhile, the pressure to return to some form of fiscal orthodoxy might create tensions both within and between eurozone member states

The festive lights on the Champs-Elysees in Paris will give way to more gloom for people in the eurozone in 2023

1 A shallow recession, followed by an even shallower recovery

The winter recession that we forecasted might turn out to be a bit milder, supported by somewhat lower energy prices and significant fiscal stimulus. On top of that, a number of sectors, like construction, still have huge order backlogs, which guarantees them sufficient activity in the short run. However, the very factors that prevent a deep recession might also restrain the recovery. Indeed, budgetary support to cope with high energy prices is likely to decrease in the second half of next year, while energy is bound to remain expensive.

At the same time, the European Central Bank's (ECB's) monetary tightening will constrain the more interest rate-sensitive sectors in 2023 and the energy supply could become critical again in the winter of 2023/24. All in all, because of the very subdued recovery, GDP growth is still likely to print a negative figure for the whole of next year.

2 Inflation will fall, but the 2% goal is not yet in sight

November 2022 marked the first time in 17 months that inflation fell, on the back of lower energy inflation. We think this trend will continue but not necessarily every single month. Even though energy prices are unlikely to fall below 2022's levels, the year-on-year comparison will be less punitive than in 2022. However, core inflation is likely to be stickier. The start of the year might see important price increases on the back of inflation indexation and energy price pass-through.

Higher wage-induced costs will also keep some upward pressure on services prices. We agree that dwindling demand and high inventories will slow the month-on-month increases in core prices over the course of the year. But even then, December 2023 is still likely to see both headline and core inflation above 3%.

3 A difficult return to budgetary orthodoxy

The multitude of shocks over the last few years have forced European governments to deliver quasi-permanent fiscal support, leading to a significant deterioration of public finances. The subdued recovery could increase pressure on governments to step up fiscal stimulus further, which in turn could bring back debt sustainability concerns. However, as the general escape clause is unlikely to be activated again for 2024, budgets for 2024 should present more restrictive fiscal policies. A clear contradiction. This will get even more complicated as another reform – the Stability and Growth Pact – is on the European agenda for 2023.

The European Commission's proposal to build in more flexibility and practice a more tailor-made and country-specific approach makes sense but will be considered as a relaxation of the rules by Northern member states. We expect fiscal tensions at both the national and European levels.

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