

## The eurozone is dealing with Delta better than most

Thanks to high vaccination rates, the eurozone economy is dealing with the Delta variant better than most, though supply chain troubles are becoming a drag on growth. Inflation is higher than expected, but is likely to fall back below 2% next year, allowing the European Central Bank to remain rather dovish



European Commission President, Ursula von der Leyen, at a news conference about the Afghan crisis

### The last shall be first

Things can change. While at the beginning of this year the eurozone was a laggard in the vaccination campaign – something we did not fail to point out repeatedly – the monetary union has now become one of the frontrunners, comfortably beating the US in terms of the number of people fully vaccinated. This explains why the Delta variant is causing less havoc in Europe, at least for the time being.

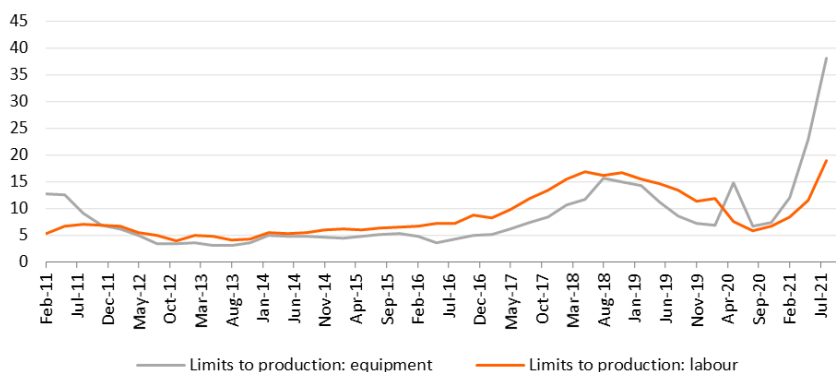
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*We're not completely out of the woods*

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That doesn't mean we are completely out of the woods. Indirectly, growth in Europe could also be affected by a temporary deceleration in the rest of the world. On top of that, global supply chain distortions have now clearly reached a point where they are starting to slow growth, especially in countries with an important manufacturing sector, such as Germany. Indeed, in manufacturing, the net percentage of companies reporting constraints on production because of a lack of inputs has reached the highest level since the survey started more than 35 years ago. At the same time, a growing labour shortage seems to be emerging, further impacting the supply side of the economy.

## Industry survey shows increasing production constraints



Source: Refinitiv Datastream

## Strong summer

To be sure, growth remains very strong. The eurozone PMI was close to a 15-year high in August, with hiring intentions and new orders still buoyant. We are now less convinced that the ending of the temporary unemployment schemes will have a big upward impact on unemployment figures, as job openings are growing rapidly. The healthy labour market is likely to unleash some of the excess savings accumulated throughout the pandemic. In that regard, we think that 3Q growth might match the surprisingly strong 2Q, before gradually starting to decelerate. On the back of the strong second quarter, we have revised our growth forecast for 2021 upwards to 4.9% and for 2022 to 4.1%.

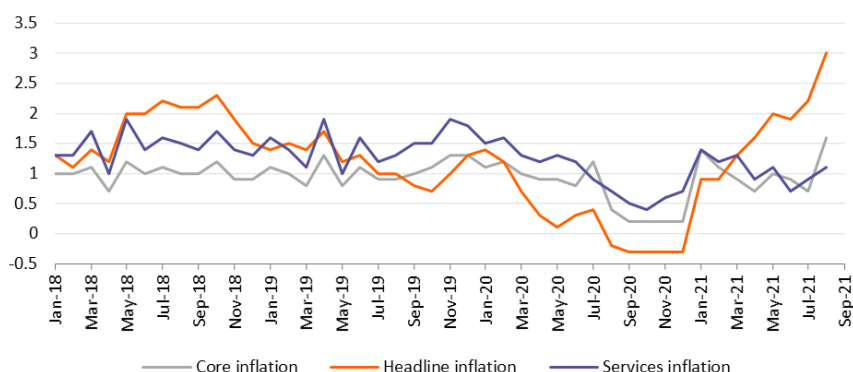
## Inflation noise

With a stronger than expected jump to 3% in August, eurozone headline inflation is now at the highest level in 10 years. Energy prices are one of the main culprits, an impact that is likely to peter out over the course of 2022. Core inflation also climbed to 1.6% but here, some statistical noise (delayed summer sales period in 2020 in some countries, creating an adverse base effect) overstated the true increase in price pressures. The fact that services inflation, albeit rising, came out at 1.1%, shows that the underlying upward trend in inflation remains subdued for now.

That said, in the wake of increasing labour market tightness and high current inflation figures, it is not hard to imagine trade unions demanding hefty wage increases. And indeed, in Germany the era of wage moderation seems to be coming to an end with employers likely to be forced to go some way to meeting trade unions' demands in the forthcoming wage round. The bottom line is that while some of the current inflation overshoot is likely to be temporary, we still believe that the underlying inflation trend is now slightly upwards. We therefore have higher inflation forecasts

than the ECB, namely 1.7% next year and 1.6% in 2023. Admittedly, these figures are still below the Bank's new symmetric inflation target of 2%.

## High, but distorted inflation figures



Source: Refinitiv Datastream

## Still dovish ECB

If anything, the ECB seems to have become slightly more dovish, with the governing council now expecting key interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon. At the same time, the ECB is still more worried about the inflation rate being too low in the medium term rather than too high. This doesn't mean that there won't be any tapering of bond purchases. Though the ECB doesn't seem to be in a hurry to give more guidance on its bond purchase programmes (this might have to wait until December), we continue to believe that the Pandemic Emergency Purchase Programme will end in March next year. At the same time, the Asset Purchase Programme will probably be increased from €20 to €60bn a month in order to have a more gradual phasing out of quantitative easing. As for interest rate policy, we now think that the ECB is unlikely to increase interest rates before 2024.

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