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3 calls for the eurozone as concerns rapidly mount

The threat of recession amid persistently high inflation is contributing to growing angst for policymakers across Europe

European leaders appear to have their backs against the wall, figuratively and literally, as problems mount

1 A recession in the eurozone

While you can argue about the precise definition of a recession, we now pencil in two consecutive quarters of negative growth, starting in the second half of 2022. The uncertainty of the Ukraine war and falling real income growth are likely to take their toll on the consumer. On top of that, the energy shock is not going to abate in the coming months, on the contrary. While oil prices are not expected to decline, natural gas prices might actually still climb higher in the winter months as reduced supply will keep the market very tight. That will further sap purchasing power and could also lead to some (temporary) closures of energy-intensive production sites. Meanwhile, the strong inventory build-up in recent months could give way to an inventory correction in the second half of the year. Finally, let's not forget that Covid-19 has not disappeared and is likely to add to the disturbances in winter.

2 ECB hikes by 100bp and then stops

With stubbornly high inflation and longer-term inflation forecasts above 2%, the European Central Bank has clearly fallen behind the curve. The very gradual process of normalising monetary policy looks increasingly misplaced. This is why we expect the ECB to step up the pace of hiking interest rates, bringing the refi rate to 1% before the end of the year. The looming recession, not only in the eurozone but also in the US, along with doubts about debt sustainability in the eurozone should prevent the ECB from going beyond the initial normalisation, keeping rates on hold in 2023.

3 Fiscal policy debate at full swing

We expect the European Commission to present its proposals on how to reform the eurozone's fiscal rules after the summer. With the ECB's anti-fragmentation tool, widening bond yield spreads and fears of a new euro crisis, the discussion of fiscal rules and debt sustainability will gain unexpected momentum towards the end of the year. Eventually, we expect this debate to lead to more powers and responsibilities but also more discretionary authority for the European Commission. A currently unused tool is the so-called Excessive Deficit Procedure on government debt. Up to now, this procedure was never started as it would practically put countries under endless fiscal surveillance. We expect the debate to not only lead to a stronger role for the European Commission but also to give more emphasis on expenditure and debt reduction.

Authors

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com