Bundle | 12 July 2022

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Germany: Unprepared for a perfect storm

Recession has become our base case but there is more: the economy is facing its biggest overhaul in decades

German Chancellor Olaf Scholz

At the start of the year, we predicted a strong cyclical rebound for the German economy over the course of 2022. Richly filled order books, relief in global supply chains and big investment plans by the German government were just a few of the ingredients in this forecast. But the war in Ukraine has changed everything. What German Chancellor Olaf Scholz had called a 'Zeitenwende' (a historic turning point) for geopolitics and military spending, has actually become a 'Zeitenwende' for the entire German economy. For several decades, the German economy has benefited from importing cheap energy and globalisation. It now no longer will.

Recession is hard to avoid

The latest hard macro data has confirmed our concern that the economy might already have contracted in the second quarter of the year. Admittedly, this is only data up to May but almost all of the data is down compared with the first quarter. If it weren't for still relatively strong business sentiment and a particularly solid current assessment, a contraction would have been the consensus view already. At face value, absolute levels of most leading indicators suggest that the German economy should have grown in the second quarter. However, supportive factors for the economy such as post-lockdown reopenings and filled order books have been losing momentum rapidly. Weaker global demand, supply chain frictions, and high inflation denting consumption are hitting the German economy. In fact, consumer confidence is already in clear recession territory and it looks as if the rest of the economy is quickly following suit.

Looking ahead, even if the current holiday mood wants to make us believe that all is well, the outlook for the German economy is anything but rosy. Currently, in the base case scenario with continuing supply chain frictions, uncertainty and high energy and commodity prices as a result of the ongoing war in Ukraine, the German economy will be pushed into a technical recession. To make matters worse, the current dry weather has reduced water levels in the main rivers close to their 2018 levels, when low water levels led to the disruption of supply chains. All of this makes for a perfect storm in the second half of the year.

Energy dependence biggest vulnerability

Needless to say that currently there are more downside than upside risks to the outlook. The single largest risk is further disruption to Germany's energy consumption and a complete stop in the Russian gas supply. Currently, Germany's gas reserves are filled by only around 60%. To get through the winter without any Russian gas, the government intended to have reserves filled up to 90%. This target increasingly looks unachievable. It will not take until the winter before the energy crisis escalates further. The government's decisions to bail out an energy company and to change the so-called pricing adjustment mechanism, which allows firms to pass on costs to the consumer, as well as the fact that NordStream 1 just went – temporarily – offline, are just a few of the dark clouds gathering. In case of a complete shut-off from Russian oil and gas, available studies suggest that the German economy could shrink by between 2% and 10% - a very wide range as assumptions in these model estimates differ significantly.

Germany's economic 'Zeitenwende'

The perfect storm in the coming quarters is not where the 'Zeitenwende' for the German economy will stop. In fact, we have often written about the need for more investment and structural changes. The war in Ukraine is the mother of all reasons for significant structural change. Actually, the war in Ukraine puts an end to the German economic business model as we knew it - a model which was mainly based on cheap energy imports and industrial exports into a increasingly globalised world. Of course, everything is possible but it does not really look as if this world will return any time soon. Instead, Germany needs to reduce its energy dependence and step up the green transition. It also needs to adjust to a world of friendshoring, in which services will increasingly take over from industrial exports. The needs for scaling up investment in education, infrastructure and digitalisation add to a long list of Germany's economic 'Zeitenwende'. In this regard, the finance minister's announcement to return to balanced budgets next year is as surprising as it is unrealistic, and in our view, rather driven by political motives than by economic foresight.

Germany's track record with structural change is not overly successful, at least not with swift structural reforms. Think of reunification or the labour market reforms of the early 2000s. In the early phases, structural reform almost always comes at an economic cost. The same holds for the current 'Zeitenwende'. Real disposable incomes of households will suffer, and companies will have increasing difficulty in dealing with the costs of higher energy and commodity prices, putting corporate profit margins under pressure. A loss of economic wealth looks like a logical consequence. However, the upside from structural change is that eventually, Germany will manage to deal with these issues and challenges. At the current juncture, this offers a scarce silver lining. For German industry and the entire economy, the green transition and the need for investment are both a challenge and an opportunity.

Germany will need time and money to manage its economic ‘Zeitenwende’. In the short run, the economy is facing a perfect storm, and a recession looks almost unavoidable. In the longer run, the economy can only return as Europe’s powerhouse if it implements investment and structural change as determined and committed as it demanded from other eurozone countries in the past.

The German economy in a nutshell %YoY

	2021	2022F	2023F	2024F
GDP	2.9	0.7	0.8	2.2
Private consumption	0.3	1.6	0.1	1.5
Investment	1.0	2.7	4.3	4.0
Government consumption	3.1	1.0	3.1	3.0
Net trade contribution	0.3	-2.5	-0.8	0.3
Headline CPI	3.1	8.0	3.5	2.2
Unemployment rate (%))	3.4	3.1	3.0	3.0
Budget balance as % of GDP	-4.3	-6.4	-4.5	-2.5
Government debt as % of GDP	72.0	78.0	71.0	68.0

Source: Thomson Reuters, all forecasts ING estimates

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France: Public spending will not prevent recession

In France, the first half of 2022 has been difficult, and the second half does not look any better, despite significant support from government spending

French President Emmanuel Macron

A difficult start to the year

After a year marked by strong GDP growth (+6.8% over the year) and a return to pre-pandemic levels of activity, 2022 has proven to be more difficult for the French economy. GDP contracted by 0.2% in the first quarter, weighed down by a sharp drop in household consumption (-1.5% over the quarter) and lacklustre exports. Weakened by the disruption to supply chains and the unfavourable specialisation of the French economy in the current context (particularly in the manufacture of transport equipment and in tourism), exports in volume terms have still not returned to their pre-pandemic level. Consumption has contracted due to the sharp fall in consumer confidence amid the war in Ukraine, and also because of high inflation which weighs heavily on household purchasing power and sentiment. France is one of the only European countries (with Denmark and Sweden) to have seen its GDP contract in the first quarter of the year, even though inflation is lower in France than in other European countries, and therefore purchasing power is less degraded. Indeed, the government has spent billions of euros to limit the impact of rising energy prices on inflation and households in France, via the so-called "tariff shield" which has drastically limited increases in gas and electricity prices, and via a rebate on fuel. Combined, these measures have reduced inflation by 1.5 to 2 points according to INSEE estimates and largely explain the inflation gap between France and the rest of the eurozone (in June, harmonised inflation stood at 6.5% against 8.6% in the eurozone as a whole).

GDP is unlikely to have recovered strongly in the second quarter of 2022. The inflationary environment has continued to weigh on household consumption and consumer confidence has deteriorated significantly. Supply chains remained disrupted, and although manufacturing output picked up in May, it is unlikely to be up for the quarter as a whole. The only positive element, which could prevent a second consecutive quarter of contraction in France, is the end of health restrictions, which should give a short-lived boost to the services sector, and in particular, to tourism-related activities which benefit from the return of international tourists. This reopening effect could continue to have a small effect on economic growth in the third quarter.

Labour market and public spending offer support

For the rest of the year, the good performance of the labour market should continue to limit the contraction in consumption. At 7.3%, the unemployment rate is close to its historic low, thanks to the very strong employment growth observed in 2021. Surveys still point to strong recruitment difficulties and thus to the potential for future job creation, but the first signs of a slowdown are beginning to emerge. We believe that the unemployment rate will remain historically low in 2022, although we expect a small increase, which should help preserve the purchasing power of French households.

Household purchasing power will also be supported by fiscal policy, which in France can currently be characterised as very expansionary. Indeed, after having already spent 23 billion euros to support households and companies in the face of inflation, the government intends to spend 20 billion more. It has just unveiled new measures that it wants to put in place, notably an extension of the tariff shield on gas and electricity, indexation of civil servants' salaries, faster indexation of pensions and social benefits, food aid for low-income households, a permanent reduction in contributions for the self-employed, a limitation on rent increases, fuel vouchers for workers and a reduction in certain taxes for all. The government's objective is therefore no longer only to limit price increases, but also to support activity (which, all things being equal, should have the effect of supporting inflation, at a time when the European Central Bank is trying to reduce it…).

A significant cost to public finances

All these measures would cost 43 billion in one year, which is much higher than what is implemented in neighbouring countries. The government has set itself the target of maintaining the deficit at 5% this year, which would be difficult to achieve in the context of the economic slowdown, and 3% in 2027, also ambitious. Moreover, all this is taking place in an unprecedented political context in France, where the government does not have a majority in parliament. This means that the measures will have to be discussed in the National Assembly. In order to reach a compromise, other costly measures could be added to the package proposed by the government.

Avoiding recession will be difficult

Although expansionary fiscal policy and a strong labour market are supporting purchasing power somewhat, we expect economic activity in France to slow down significantly in the coming quarters. Inflation, which is expected to remain between 6% and 7% until the end of the year, will continue to weigh on consumption. The global economic slowdown will have an unfavourable effect on exports, while possible interruptions in gas supplies will have a negative impact on industrial activity. Taking all these factors into account, we expect GDP to contract in the fourth quarter of 2022, as well as in the first quarter of 2023, before a very gradual recovery. This implies that, after expected GDP growth of around 2.1% on average for the year 2022, growth for 2023 could be close to 0% (we currently expect 0.3%).

The French economy in a nutshell

(% YoY)	2020	2021	2022F	2023F	2024F
Demand and output					
GDP	-7.9	6.8	2.1	0.3	1.4
Private consumption	-6.8	5.3	1.9	-0.1	1.7
Investment	-8.4	11.4	1.3	1.2	1.8
Government spending	-4.1	6.3	2.1	0.5	1.2
Net trade contribution (% points of contribution to GDP)	-1.1	-0.1	0.2	0.0	-0.1
Labour market					
Unemployment rate (%, Eurostat)	8.1	7.9	7.4	7.7	7.9
Government finances					
Budget balance as a % of GDP	-9.1	-6.5	-5.0	-4.4	-4.0
Government debt as a % of GDP	115	114	114	113	112
Prices					
Inflation (HCPI)	0.5	2.1	5.9	3.3	1.8

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Italy: The positive ‘reopening’ effect will be temporary

We expect the Italian economy to enjoy temporary support from a tourism-related reopening effect over the second and third quarters. This will evaporate,...

Italian Prime Minister, Mario Draghi

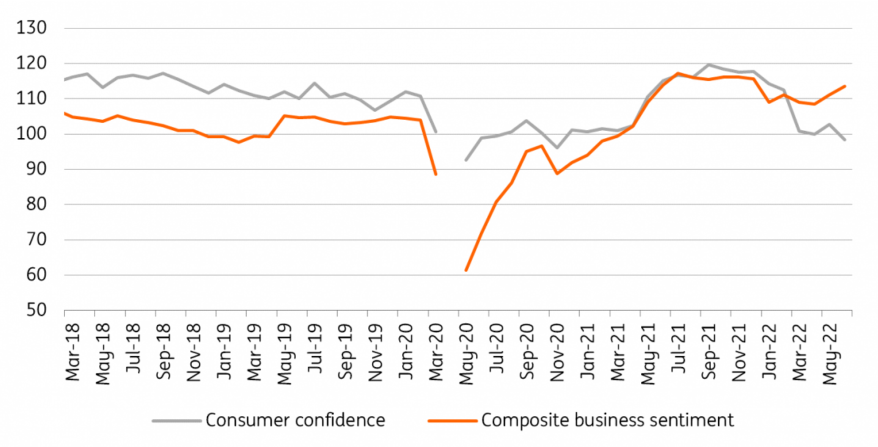
Investment helps Italy avoid a first-quarter contraction

The Italian economy just managed to post a modest 0.1% Quarter-on-Quarter growth in the first three months of the year, with investment as the sole growth driver. Given the deteriorating external background, the contraction of private consumption was far from surprising. Households, notwithstanding improving employment conditions, had their disposable income eroded by an unanticipated inflation wave already before the start of the war in Ukraine. Consumer confidence declined accordingly, confirming a more cautious twist in consumer behaviour. This was mirrored by an increase in household savings rates, which climbed to 14.6% in the first quarter, moving further away from the 10% pre-Covid average.

Consumption's changing and non-durables and tourism will benefit

As we move into the second quarter, we're getting conflicting signals as far as confidence is concerned. Consumer confidence has fallen further while business confidence broadly stabilised in industry and improved markedly in services. How do we reconcile this? We suspect that the measures put in place by the Italian government to help households weather the inflation shock, such as temporary cuts to energy taxes and other fixed costs along with a lump sum to lower earners, have not been sufficient to compensate enough and subsequently improve their mood. At the same time, businesses have benefited from a continuous stream of incoming orders (particularly in industry) and of a re-opening effect as the last anti-contagion restrictions were lifted.

Mixed signals from confidence data



Source: Refinitiv Datastream

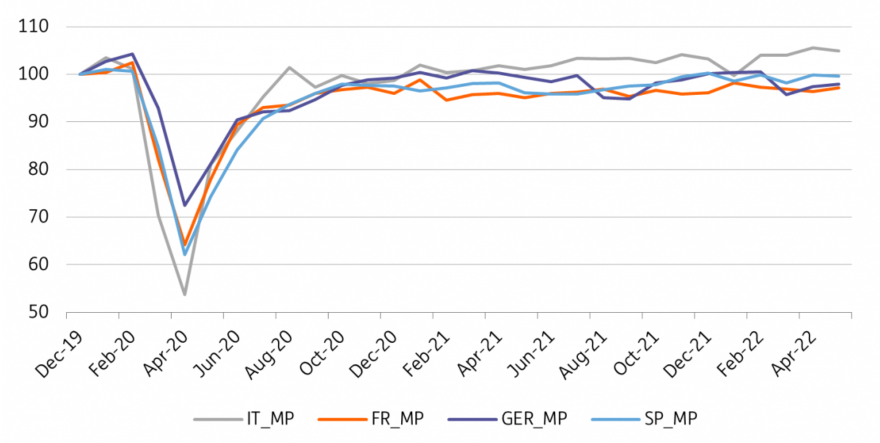
Growth will be supported by a tourism recovery in the summer

The acceleration of inflation over the second quarter - headline HICP inflation reached 8.5% in June and it doesn't look like it's going to fall anytime soon - has persuaded the Italian government to extend the compensation measures until the end of the third quarter. Conditions are right for a temporary modification in consumer behaviour, where budget-constrained households reduce consumption of durables in favour of non-durables and services, particularly tourism. Indeed, barring very negative surprises from the pandemic front, the summer of 2022 might mark a return of tourism back to pre-Covid levels. Tentative evidence from recent surveys run by the confederation of tourism operators and from balance of payments data seem to support this view. The continued acceleration of "re-opening" inflation (at 5.4% in June) is also possibly signalling that tourism-related demand already accelerated in the spring.

Industry should also be growth supportive

Another short-term factor temporarily supporting growth in the second quarter is the resilience of Italian industry, which has consistently overperformed peer core countries since early 2021, possibly thanks to a specialisation pattern less vulnerable to long-lasting supply chain disruptions. With May data now in the bag, it seems highly likely that in the second quarter, industry will be again a growth driver. In perspective, we should not forget that the inflowing European recovery and resilience funds will provide solid support to domestic industry, particularly at times when the energy transition and related investments have become a national top priority to make the country less dependent on Russian gas.

Italian manufacturing production resilience continues



Source: Refinitiv Datastream, ING Research

Public finances will likely enjoy temporary favourable conditions, helped by inflation

In the meantime, the impact of unexpectedly high inflation and of the phasing out of one-off Covid-related emergency measures is showing up in public accounts, which posted a substantial YoY improvement of €44bn over the first six months of the year, notwithstanding the set of temporary measures put in place by the government As the so-called inflation tax is also working to reduce the real value of the debt, in 2022 the combined effect should be a reduction in the debt/GDP ratio to around 147.5% (from 150.4% in 2021). But make no mistake: to keep such a pace in less inflationary times, a combination of decent growth and sustained primary surpluses will be needed, as in pre-Covid days.

The Italian economy in a Nutshell (YoY%)

	2021	2022F	2023F	2024F
GDP	6.6	2.9	0.8	1.9
Private consumption	5.2	1.8	0.4	1.6
Investment	17.0	10.9	4.4	2.4
Government consumption	0.6	0.5	0.8	0.5
Net trade contribution	0.0	-0.6	-0.2	0.3
Headline CPI	1.9	7.5	3.8	1.9
Unemployment rate (%)	9.5	8.7	8.7	8.4
Budget balance as a % of GDP	-7.2	-5.8	-5.5	-4.1
Government debt as a % of GDP	150.4	147.4	147.4	145.8

Source: Refinitiv Datastream, all forecasts ING estimates

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Spain: Tourism to drive economic upturn, but the outlook is cloudy

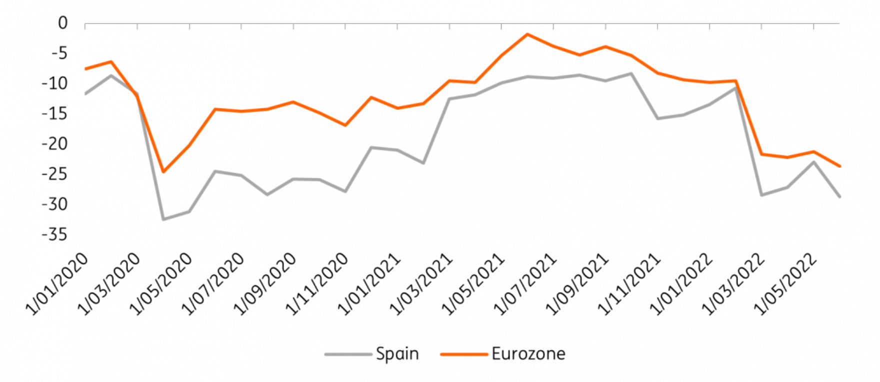
High uncertainty related to the war in Ukraine and soaring inflation are expected to cool down the Spanish economy in the second half of the year....

The Prime Minister of Spain, Pedro Sánchez

Things are starting to look worse for Spain

The ongoing war in Ukraine and the erosion of purchasing power due to high inflation are expected to adversely impact economic activity. Households are becoming more pessimistic as soaring inflation bites, with consumer confidence plunging again in June. This could contribute to a slowdown in the economy later this year. However, the latest consumption data for May show no weakening (yet). Business activity is also holding up for the time being. The purchasing manager indices show that both the manufacturing and services sector in Spain weakened in June, although they are still above the 50-mark indicating they have still grown compared to May. The fall in both PMIs was slightly more pronounced in Spain than in the eurozone.

Consumer confidence plunged again in June



Source: Refinitiv, ING Research

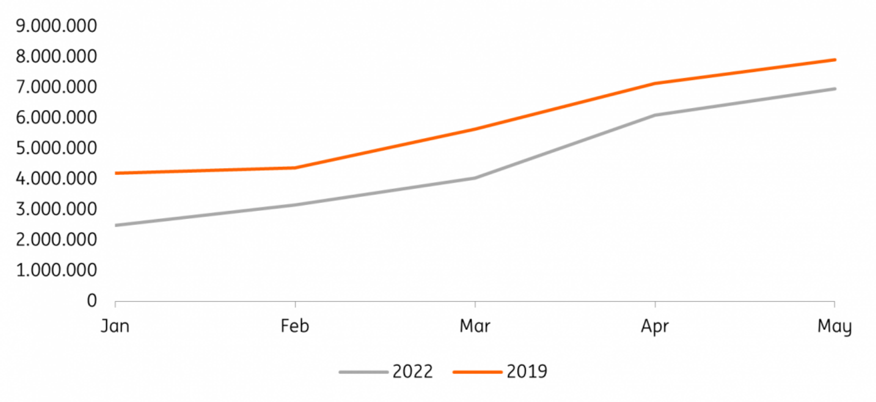
Inventory correction and a weakening in export demand are also worsening the outlook for Spain. As part of ongoing efforts to circumvent rising prices and supply chain problems, firms subsequently built up their stocks in the spring, but a weakening demand from autumn is likely to prompt companies to correct their inventories. On top of that, a slowdown or recession among Spain's main trading partners will reduce exports. On the other hand, a strong labour market, a government package to cushion the loss in purchasing power (adding five basis points to the growth figure in 2022 and 2023, according to the Spanish central bank), and a continued recovery of the tourism sector, will help ease the pain.

Since Spain is one of the eurozone members least directly affected by the war in Ukraine, we expect the country to stay just out of recession territory during the coming winter months.

Tourists to the rescue?

In May, Spain welcomed seven million international tourists, which means it recovered 90% of the international tourists recorded in 2019. Total tourist expenditures are also already at 90% of their pre-covid level in real terms. The elimination of Covid restrictions led to a strong acceleration of inbound tourist flows in the first half of the year, which were at the heart of the solid contribution of the exports of services to GDP growth. We expect that international tourism will continue to recover over the summer months, although soaring inflation might start to slow tourist activities down. As tourism is a key economic sector in Spain, contributing 14% of total GDP in 2019 according to the World Travel and Tourism Council, a continued recovery is a substantial factor underpinning economic growth.

International tourist arrivals



Source: Refinitiv, ING Research

Higher inflation is hitting demand

In June, consumer prices rose by 10.2% year-on-year (HICP inflation 10%) from 8.7% in May, bringing inflation to its highest level since 1985. More worrying was that core inflation was also up again, from 4.9% in May to 5.5% last month. Looking ahead, the introduction of the Iberian mechanism to cap gas prices for electricity production, and a package of government measures including a VAT tax cut on electricity, are expected to cushion inflation in the second half of 2022. However, the impact will be reversed completely in 2023, which has led us to increase our inflation forecast for next year to 3.1%. Although business surveys indicate that inflationary pressures are easing somewhat, elevated price pressures are likely to persist in the near term at least. As total input costs rose again at an elevated level in June, this will lead to other rounds of price mark-ups in the months ahead. Until now, market demand was sufficiently resilient to absorb higher prices, but this now seems to be turning around as household budgets are increasingly under pressure. If these second-round effects materialise, this is expected to substantially slow down consumer spending over the next few months.

Spain's job market improves, helped by labour market reform

There has been strong employment recovery in Spain. In June, registered unemployment stood at its lowest level since October 2008. June 2022 also recorded the largest increase in new jobs since 2005, albeit the start of the summer season traditionally prompts growth in temporary employment. The largest increase was recorded in the hospitality industry which is still benefitting from the elimination of Covid restrictions. A mix of domestic reopening tailwinds and a recovery of tourism will support employment growth in the second and third quarters of 2022. Employment expectations have also held relatively firm since the onset of the war. In June, jobs continued to be added with capacity constraints persisting and backlogs still elevated. However, we expect this trend to be reversed in 2023.

Current headwinds to economic growth are mounting and will adversely impact employment next year. Although the recent labour market reforms initiated in Madrid improved the proportion of permanent contracts relative to temporary ones, the swings in unemployment rates might be more pronounced than in other eurozone countries as the share of temporary contracts still exceeds the eurozone average. Nevertheless, we expect the impact on the labour market to be moderate unless the outlook deteriorates further.

All in all, the reopening of the economy and recovery of tourism supported growth in the second quarter, but the outlook is cloudy for Spain. For 2022 and 2023, we expect 3.8% and 1% economic growth, respectively.

The Spanish economy in a nutshell (% YOY)

	2021	2022F	2023F	2024F
GDP	5.1	3.8	1.0	2.1
Private Consumption	4.6	0.9	3.1	2.3
Investment	4.3	6.0	-1.4	0.7
Government Consumption	3.1	-0.3	0.3	1.9
Net trade contribution	0.5	1.7	-2.2	-0.3
Headline CPI	3.0	7.2	3.1	2.1
Unemployment rate (%)	14.8	13.3	13.6	13.1
Budget balance in % of GDP	6.9	4.9	4.6	4.3
Government debt in % of GDP	118.4	115.7	116.1	115.4

Source: Refinitiv, all forecasts ING estimates

The Netherlands: We're seeing the first signs of weaker demand

Dutch GDP is forecast to grow by a decent 2.9% in 2022 and a mediocre 0.8% next year Expansionary fiscal policy, a tight labour market, and high savings...

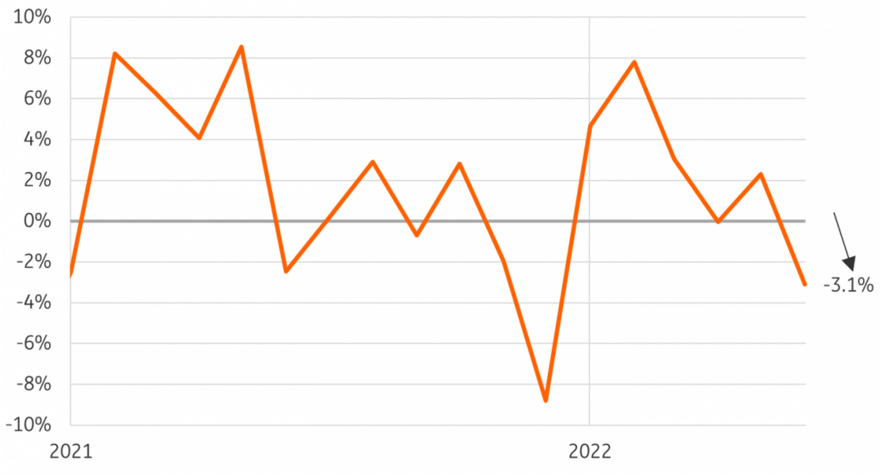
The Dutch Prime Minister, Mark Rutte

High inflation and low consumer sentiment mean stagflation

A lot of hard data on the Dutch economy is still quite solid. For instance, the unemployment rate is close to record lows and consumption volumes have never been higher than in April. But this is the past; the outlook is somewhat less favourable. ING transaction data suggests a substantial fall in consumer spending in June, seasonally-adjusted Month-on-Month. As this is the first serious signal, it requires careful interpretation. We nevertheless are now forecasting a fall in household consumption in the second half of 2022, as high energy payments, increasing core inflation and record low consumer confidence are expected to weigh on consumers' budgets. As the amounts deposited on household bank accounts have never been higher and employment is still at record highs, the consumption outlook may not as bad as confidence figures suggest.

Value of consumer transactions declined in June

Change in total value of debit card transactions, cash withdrawals and iDEAL payments of Dutch consumers compared to previous month, seasonally-adjusted



Source: ING data, calculations by ING Research

High energy and fuel a problem this year with more to come in 2023

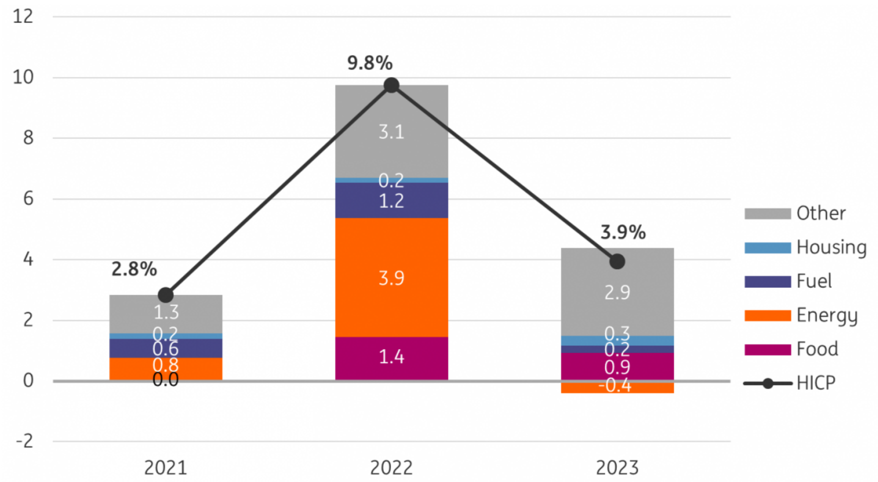
Much of the GDP development currently depends on inflation. The HICP inflation rate is forecast to be very possibly close to double-digit highs in 2022 and still at a 3.9% high in 2023. When you look at the volatile future and forward energy and fuel markets, our forecasts don't see any major fall until winter is over next year. But that contribution to overall inflation rates will fade in 2023. Food inflation is expected to be substantial not only this year but also next.

The following policy measures have a direct effect on the inflation rate for 2022 and 2023, in many cases preventing the 2023 HICP inflation rate from falling towards a more moderate level:

- The energy tax (on gas and electricity) is temporarily lower for 2022. The reversal in 2023 will have an upward effect on inflation for 2023.
- The VAT-rate on energy will be lowered from 21% to 9% for July-December 2022. This has a suppressing effect on inflation this year and an upward effect for 2023.
- The excise duty on fuel (gasoline and diesel) is lowered 21% until December 2022. Also, this measure has a temporary downward effect on inflation in 2022 and an upward effect on for 2023.
- College tuition fees are half of what they used to be and will be normalised in September 2022. This affects the 2023 inflation upwards (+0.3%-points).
- Regulation keeps a lid on the increase of rents in both the social housing sector and the liberalised sector, at least until policy changes as of 1 July 2022 and 1 January 2023. This might be more inflationary for the second half of 2022 and 2023.
- The excise tax on a pack of cigarettes will be increased in two substantial steps, to €10. The first step in April 2023 is estimated to have a nonnegligible effect on the HICP inflation rate of +0.5% in 2023.

Inflation very high in 2022 and high 2023

Change in harmonised index of consumer prices for the Netherlands year-on-year in % and contributions in %-points



Source: Macrobond, forecasts as of 2022 by ING Research

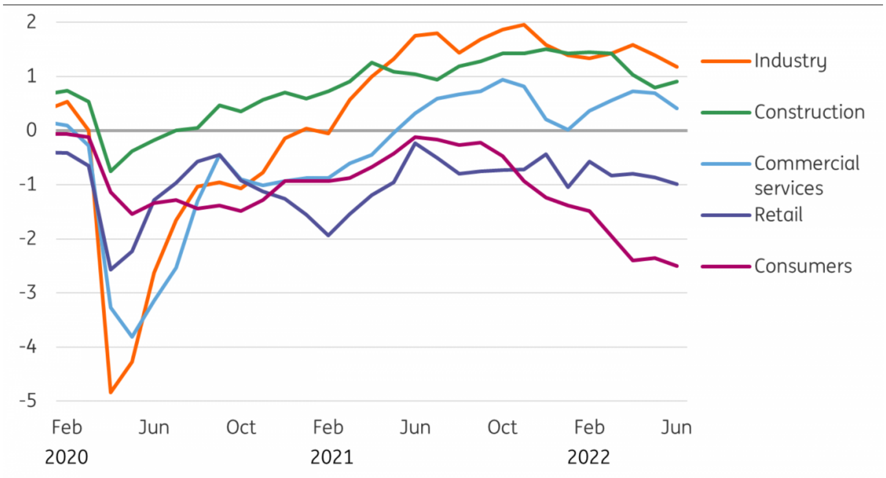
Average level of sentiment implies moderate investment outlook

So far, businesses seem to have been holding up quite well, in part because high import inflation was, to a large extent, offset by high increases in the price of exports. As the underlying indicators of the Economic Sentiment Indicator suggest, they are not as pessimistic as consumers. Industry, construction, and commercial services to a lesser extent are still upbeat. The composite sentiment indicator of 29 out of 36 (sub)sectors is still above long-term averages.

All in all, the survey data does not indicate a full-blown recession. But since these figures might still to some extent be influenced by the rebound out of lockdowns, we do pencil in a few quarters with negative growth. This assumes that investment remains more or less unchanged year-on-year, private consumption falls, and exports continue to grow (as service trade still rebounds from the pandemic lows).

Business sentiment in most sectors still decent while consumers gloom

Economic Sentiment Indicator by sector*



Source: European Commission via Macrobond, calculations ING Research

*Seasonally adjusted and in standard deviations from long term mean

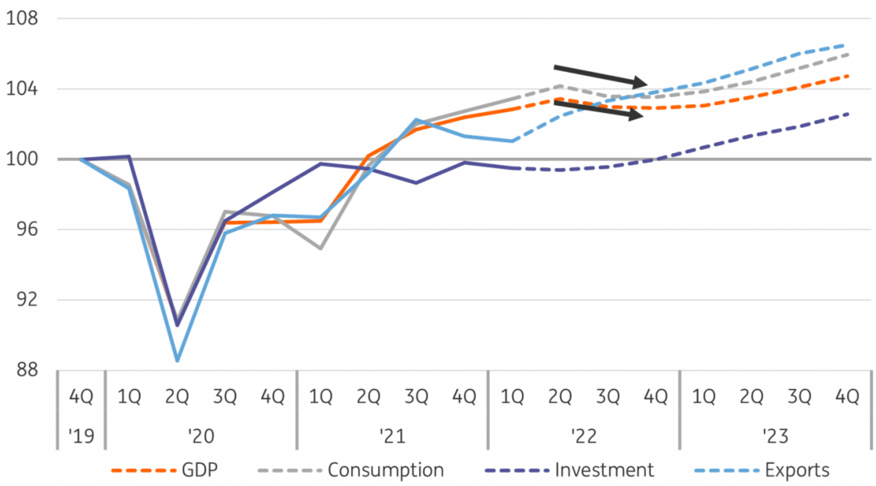
Expansionary policy helps recession remain a technical one

The GDP growth figure for 2022 of 2.9% in our base case looks very decent at face value, but most of this is a statistical carry-over from last year. The underlying dynamics are merely in line with stabilisation. As the Netherlands is not as likely to benefit from the tourist season as much as destinations such as Italy, France and Spain, Dutch GDP might already enter a mild technical recession in 2022.

During the course of 2023, GDP should gain some traction again on the back of falling inflation, resulting in an annual growth figure of 0.8%. This growth rate for 2023 is to a large extent supported by the expansionary policies of the Rutte-IV government and requires energy supply issues to remain manageable.

Consumption causes technical recession

Expenditures* as index where fourth quarter of 2019 = 100



Source: Macrobond, forecasts ING Research from 2Q22

*Seasonally-adjusted and in constant prices

The Dutch economy in a nutshell (%YoY)

	2021	2022F	2023F	2024F
GDP	4.9	2.9	0.8	2.1
Private consumption	3.6	5.8	0.2	2.1
Investment	3.3	0.2	2.0	2.4
Government consumption	5.2	0.7	2.7	3.1
Net trade contribution (%-point)	1.5	-0.1	-0.6	-0.1
Headline HICP	2.8	9.8	3.9	1.8
Unemployment rate (%)	4.2	3.4	3.6	3.4
Budget balance (% of GDP)	-2.6	-3.2	-3.0	-3.1
Government debt (% of GDP)	52.4	51.9	52.6	53.5

Source: Macrobond, all forecasts as of 2022 ING Research estimates

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Belgium: Who will pay the inflation bill?

The strong inflation wave is partly being cushioned by the automatic indexation of many incomes, at the price of a deterioration of competitiveness and...

Belgian Prime Minister Alexander De Croo

Satisfactory start to the year...

In the first quarter of this year, the Belgian economy again recorded positive growth of 0.5% compared to the previous quarter. This relatively good performance is due to household consumption (+0.5% quarter-on-quarter) and business investment (+2.7%). But it must be said that the change in inventories also contributed half a point of growth. On the other hand, public spending contracted sharply. On the supply side, most sectors contributed positively to activity, with the notable exception of the manufacturing sector, where activity contracted by 0.7%. The difficulties encountered in supply chains partly explain this disappointing development.

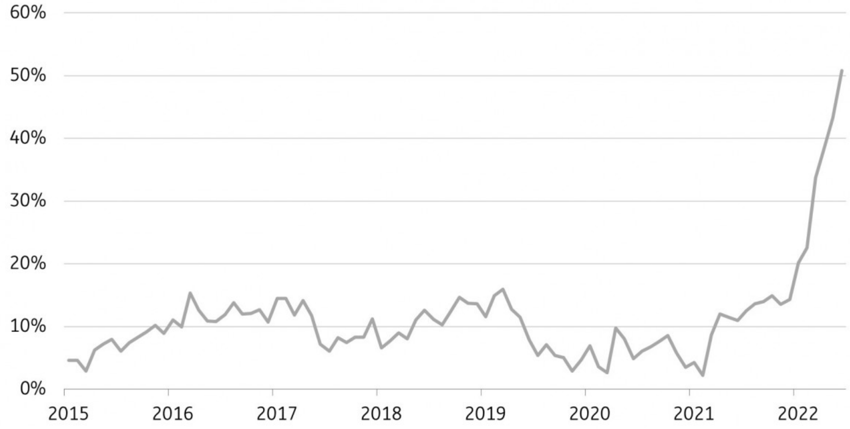
The recovery of 2021, which continued into 2022, still led to the net creation of more than 22,000 jobs in the first quarter, which is still very dynamic. As a result, the unemployment rate remains very low (5.6%).

... but inflation complicates the situation

That being said, the economic context has become much gloomier in recent months: the supply chain problems are not getting any better due to the strong slowdown in China. And the war in Ukraine has lowered consumer confidence and prolonged and amplified the wave of inflation that began in 2021.

In June, inflation reached 10.5% according to Eurostat's harmonised definition. The contribution of energy prices to inflation remains by far the most important, but it is tending to stabilise. On the other hand, inflation initially driven by energy prices is increasingly spreading throughout the economy, affecting the vast majority of products and services. In June, half of the consumer price index was up by more than 5% over one year (graph 1) and almost 90% of the index is up by more than 2%. It seems, therefore, that increases in commodity prices (including energy), transport costs, and wage costs are now leading to a general rise in prices. Such a development is not likely to disappear quickly. We expect that, under our energy price assumptions, inflation will still be close to 7% at the end of the year, and remain above 2% throughout next year.

Share of consumer price index that increased more than 5% over the past 12 months



Source: Statbel, ING

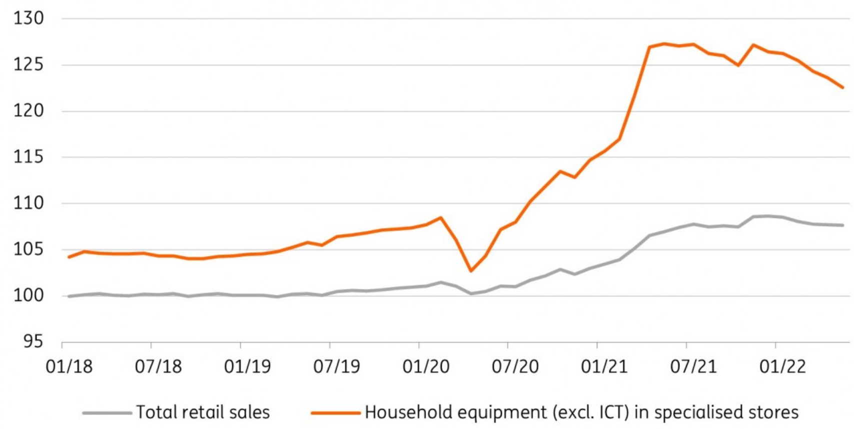
Indexation protects the consumer, but only partially

Even if it is the direct consequence of external shocks, such a wave of inflation also becomes a shock for the economy. It will therefore not be without consequences. The difficulty lies in knowing who will be the main victim.

Belgium differs from most other countries in that an automatic indexation system exists for most incomes: wages in the private and public sectors, pensions, and all social benefits. Thus, according to the National Bank, households' real disposable income is expected to increase slightly in Belgium this year, whereas in the eurozone it is expected to contract by almost 1%. However, the indexation system does not perfectly protect households from all price increases. On the one hand, some prices (transport fuel, alcohol and tobacco) are excluded from the index used to calculate the indexation. On the other hand, some incomes are indexed with a delay (sometimes almost a year) on the evolution of prices. Purchasing power can therefore be affected, at least temporarily.

It is therefore not surprising that, despite the automatic indexation of incomes and the measures taken by governments to counter the rise in energy prices, retail sales are stagnating in real terms, and some of their components are even declining (graph 2). For the second half of the year, we expect continued high energy prices and the uncertain geopolitical context to dampen consumer spending further, especially on durable goods.

Retail sales (in real terms) seem to be affected by the higher energy bill (2015 = 100)



Competitiveness problem

So far, business sentiment has been more resilient to the shocks of this year. This is probably because many companies still believe that they will be able to pass on higher production costs (including labour costs) to their selling prices. However, the slowdown in demand that we expect may change their minds. Moreover, companies will increasingly face the problem of competitiveness. Indeed, the automatic indexation of wages should cause an increase in hourly wage costs of 5.5% this year and more than 6% in 2023, compared to +3% (2022) and +4% (2023) on average in the three neighbouring countries (France, Germany and the Netherlands). This very sharp rise means that companies are in fact bearing a large part of the inflation wave. The resulting loss of competitiveness is likely to weigh on economic activity and employment.

Public finances are a problem

Governments have already taken action to address the sharp rise in energy prices, notably by lowering VAT on electricity and gas. Many households also benefit from a preferential rate on their energy bill. A €225 voucher has also been given to households heating with fuel. A new package of measures could be introduced in the next few months, as the federal government has commissioned a group of experts to make proposals on the subject.

That said, all these measures have a cost that comes on top of public finances that have already been severely eroded in recent years. If we add to this the fact that the political parties forming the federal government majority are struggling to agree on important structural reforms (pensions, tax reform), a clear improvement in the public deficit seems difficult to imagine in the near future.

Faced with the very high inflation wave that the Belgian economy is experiencing, households are probably less exposed than in other countries to the deterioration in purchasing power. Through automatic wage indexation, companies partly compensate for the rise in prices for employees, but at the cost of a deterioration in their competitiveness. Public finances are also taking their share of the burden, through the indexation of pensions and social benefits, but also through the measures taken to counter the rise in energy prices. This is good for households, but it should not be forgotten that, in the end, companies and public finances also have an impact on the financial health of households, via employment or future tax increases.

The Belgian economy in a nutshell

(% YoY)	2020	2021	2022F	2023F	2024F
Demand and output					
GDP	-5.7	6.2	2.2	0.5	1.5
Private consumption	-8.2	6.4	3.4	0.4	1.7
Investment	-6.1	7.8	0.2	1.7	1.5
Government spending	-0.4	4.4	1.7	2.0	1.8
Net trade contribution (% points of contribution to GDP)	0.4	0.6	-0.2	-0.1	-0.6
Labour market					
Employment net variation	0.0	1.7	1.5	0.3	1.3
Unemployment rate (%, Eurostat)	5.8	6.3	5.5	5.4	5.4
Government finances					
Budget balance as a % of GDP	-9.0	-5.5	-5.2	-4.9	-4.7
Government debt as a % of GDP	112.8	108.2	106.0	105.9	106.8
Prices					
Inflation	0.7	2.4	8.4	4.1	2.1

Source: Refinitiv Datastream, ING computation

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Austria: When it rains it pours

Austria had just left its Covid winter and political troubles behind when the start of the war in Ukraine brought new difficulties. A rebound in tourism...

The Austrian Chancellor, Karl Nehammer

A deteriorating outlook

Slightly surpassing its pre-pandemic level, the Austrian economy grew by 1.5% quarter-on-quarter in the first three months of 2022. Industry, construction, and trade contributed to growth in the first three months of the year, but hospitality and accommodation also gained some tailwinds on the back of relaxed Covid containment measures and the return of skiing tourists.

With the start of the war in Ukraine, the economic outlook has deteriorated sharply. As one of the eurozone countries most dependent on Russian gas, Austria is clearly feeling the effects. The small industrial nation imports around 90% of the gas it needs each year, with only 10% covered by domestic production. Eighty percent of gas imports come from Russia. Of the total gas consumption, industry requires around 40%.

Old and new supply chain frictions are also weighing on industrial activity. Consequently, it is not surprising that the leading indicators for industry do not paint a rosy picture of the future. The PMI for manufacturing most recently stood at 51.2, the lowest level since November 2020, when Austria was hit by its second Covid wave.

And consumers are not optimistic about their economic future either. The assessment of households' financial situation in the coming 12 months, as measured by the OeNB's consumer confidence indicator, was at a record low in June, mainly due to high inflation. Measured by the harmonised consumer price index, inflation stood at 8.7% year-on-year in June. A similarly high value was last reached in 1975 during the oil crisis. To ease the burden on consumers and businesses, the Austrian government launched a relief package in June. Among other things, the package includes financial subsidies and relief for low-income households, the postponement of the introduction of a CO2 tax, originally planned for July, until October, and a one-off payment. Although this should provide some relief for households, government support will not compensate for the loss of purchasing power.

The total volume of all measures amounts to €28bn until 2026, which means that government debt will rise in nominal terms in 2022. However, the government does not expect the debt ratio to deteriorate significantly, as high inflation would lead to higher tax revenues and private consumption would be boosted. In our opinion, this is too naive a view. We expect the debt ratio to continue to decline, but at a slower pace than in 2021. At the end of 2022, it should stand at around 80% of GDP, compared with 82.8% of GDP at the end of 2021.

A desperate search for qualified staff

The seasonally-adjusted unemployment rate (Eurostat) stood at 4.8% in May, which is 0.1 percentage points below the level in May in the pre-pandemic year 2019. However, another problem has spread to the Austrian labour market: there is a shortage of workers in many sectors, and the situation is particularly tense in the tourism industry. More than one in two businesses in the accommodation sector recently complained that a shortage of labour was weighing on activity, according to the latest DG ECFIN's services survey.

In the food and beverage services sector, almost 50% of companies reported being burdened by a lack of workers, and in the travel agencies, tour operators and reservation services sector, it was almost one in three companies. Wage pressure, stemming from the shortage of labour, as well as the general increase in food and energy prices, is likely to cause sharp price markups in the tourism sector over the year. Since summer holidays are generally already planned at this point in time, it is quite possible that the loss of household purchasing power will not affect demand in the tourism industry until the winter. However, this is the more important season for the Austrian tourism industry.

When it rains in Austria it pours: industry is suffering from high prices and supply bottlenecks, consumers face an unprecedented loss of purchasing power, and the only silver lining on the horizon, tourism, is burdened by a shortage of skilled workers. In the short term, summer tourism could still provide some tailwind, but in the longer term, high energy prices, gas shortages and general price increases will plunge not only tourism but the entire Austrian economy into stagflation – at best.

The Austrian economy in a nutshell (%YoY)

	2021	2022F	2023F	2024F
GDP	4.5	3.5	0.2	1.8
Private Consumption	3.3	3.9	1.8	3.0
Investment	4.0	3.0	2.0	4.0
Government Consumption	6.7	-0.5	0.8	0.5
Net trade contribution	0.1	-1.0	-0.3	0.5
Headline CPI	2.8	7.0	3.0	2.0
Unemployment rate (%)	6.2	4.5	4.4	4.4
Budget balance in % of GDP	-5.9	-3.0	-1.5	-0.5
Government debt in % of GDP	82.8	79.5	77.4	72.0

Source: Thomson Reuters, ING estimates

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Greece: Tourism to help weather the inflation storm

Double digit inflation will likely weigh on domestic consumption but strong tourism inflows over the summer should help keep the economy afloat

The Greek Prime Minister, Kyriakos Mitsotakis

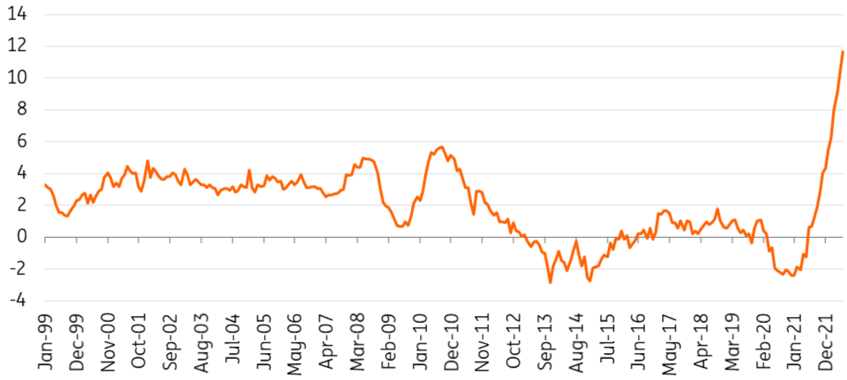
Strong start to 2022, notwithstanding inflation

The Greek economy started 2022 on a strong footing, with all demand components providing a positive contribution to the 2.4% quarterly growth. Despite the speedy rise in inflation, private consumption proved the most powerful growth driver, possibly reflecting the impact of improving labour market conditions. In the first quarter, employment was up 11% YoY and the unemployment rate fell to 12.5%, the lowest level since August 2010.

The Ukraine war's impact on commodity prices is bound to impact this positive pattern but it won't derail the Greek recovery, at least in the short term. The energy price shock, amplified by the war, is now showing up in full, with headline HICP inflation at 11.6% in June, and the much-exposed housing and transport components at 31% and 25%, respectively. The 12% yearly gain of the food component is also a reason of concern, as it will also hit lower-income households particularly hard.

Admittedly, pressure on low earners' disposable income is being partly compensated by an increase in the minimum wage, but domestic consumption is expected to suffer nonetheless in the second quarter. Consumer confidence lately started to fall again, with households lamenting increasing budget pressures. An eventual shortfall from the domestic consumption front could be at least partially compensated by a solid return of international tourist flows.

Double digit HICP inflation to weigh on domestic consumption



Source: Refinitiv Datastream

A positive tourism summer season seems likely

Early indications from the tourism sector mean there's some optimism about developments over the summer season. International travel services data for April showed that travel receipts were above the corresponding month of 2019 (in pre-Covid times), with both average expenditure per trip and inbound tourist flows on the increase. Most Covid-related health restrictions were lifted in May and it seems unlikely they will be re-instated just at the start of the summer season, notwithstanding a recent rise in cases.

Travel receipts might soon get back to pre-Covid levels

Source: Bank of Greece

The implementation of projects financed by European Recovery and resilience funds (RRF) is another potentially powerful source of support for Greek growth, which will likely act through the investment channel, more specifically in the energy and construction sectors.

Public finance ratios to improve further

The public finance picture seems yet to have benefited from the combined effect of reopening-related GDP growth and inflation on tax revenues. The recent spread widening episode fueled by the acceleration in the normalisation of the ECB's monetary stance has not altered the debt sustainability picture, at least in the short run.

With an average time to maturity of more than 18 years, substantial interest rate shocks can be accommodated quite easily and the inflation tax effect on debt works most effectively. A decline in the debt/GDP ratio to the area of 186% of GDP (from 193% in 2021) seems a distinct possibility. By aiming at a primary surplus in 2023, the Greek government is sending an important credibility message in a pre-election year. Debt sustainability requirements in a normalising inflation environment will indeed require a return to a sustainable combination of primary surpluses and decent GDP growth.

The Greek economy in a nutshell (YoY%)

	2021	2022F	2023F	2024F
GDP	8.0	4.2	1.7	2.3
Private consumption	8.1	5.7	-0.1	2.2
Investment	19.3	7.8	2.8	6.0
Government consumption	3.9	1.7	0.8	0.4
Net trade contribution	0.8	0.9	0.2	0.0
Headline CPI	0.6	9.7	3.9	1.9
Budget balance as a % of GDP	-7.4	-5.0	-3.1	-1.6
Government debt as a % of GDP	193.3	183.7	178.7	173.6

Source: Refinitiv Datastream, all forecasts ING estimates

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Portugal: Europe's growth champion plagued by uncertainty

While first-quarter growth was among the highest in the eurozone, Portuguese people feel very concerned about the economic consequences of the war in Ukraine

Portuguese Prime Minister, Antonio Costa

Uncertainty caused by the war bites harder in Portugal

Thanks to strong domestic demand and a revival of tourism, GDP surpassed its pre-pandemic level in the first quarter of the year. However, the economy is suffering from high inflation, supply chain disruptions, and uncertainty related to the war in Ukraine. A special survey conducted by the European Commission between the middle of April and the middle of May reveals that Portuguese people are more concerned about the war than the European average and feel less prepared to deal with the consequences of the conflict. Although its direct links to Russia and Ukraine are limited, the barometer ranks Portugal as the second country in the European Union (after Bulgaria) to "most feel the economic consequences of the war in Ukraine" while many other countries said they "haven't felt any yet".

Hot tourism season underpinning economic growth

Portugal will experience a hot tourism season as flight bookings have already surpassed pre-pandemic levels according to data provider ForwardKeys, with Portugal the fourth most popular holiday destination in Europe. The recovery of tourism is a substantial factor in underpinning economic growth for this year, as the sector's total contribution to GDP accounted for 17.1% of GDP in 2019. Exports are expected to grow by more than 13% this year, thanks to a strong recovery in services exports linked to tourism. Tourism is expected to remain buoyant over the next few years, growing at a much faster pace than the rest of the economy.

First-quarter momentum is losing ground

Household consumption was one of the major pillars of support at the start of the year, but this is expected to slow down due to war uncertainty and the drop in purchasing power, driven by high inflation. Nevertheless, the Portuguese economy is still projected to grow by 6.6% in 2022, thanks to a strong carry-over effect from 2021 and an accelerating economy in the first quarter of the year. However, the strong momentum of the first quarter is likely to deteriorate over the remainder of the year. In 2023 and 2024, real GDP is forecast to grow by 1% and 1.4%, respectively.

The Portuguese economy in a nutshell (% YOY)

	2021	2022F	2023F	2024F
GDP	4.9	6.6	1.0	1.4
Private Consumption	4.5	5.5	-0.4	0.9
Investment	6.4	5.3	6.0	4.4
Government consumption	4.1	2.5	-2.5	-0.8
Net trade contribution	-0.9	0.5	2.3	-0.4
Headline CPI	0.9	5.9	2.7	2.0
Unemployment rate (%)	6.6	5.7	5.7	5.5
Budget balance as a % of GDP	127.4	119.2	115.4	112.1
Government debt as a % of GDP	-2.8	-1.8	-1.3	-0.6

Source: Refinitiv, all forecasts ING estimates

Ireland: In structurally strong shape

Recent Irish data looks feeble under the hood, but structural developments remain favourable for a higher rate environment

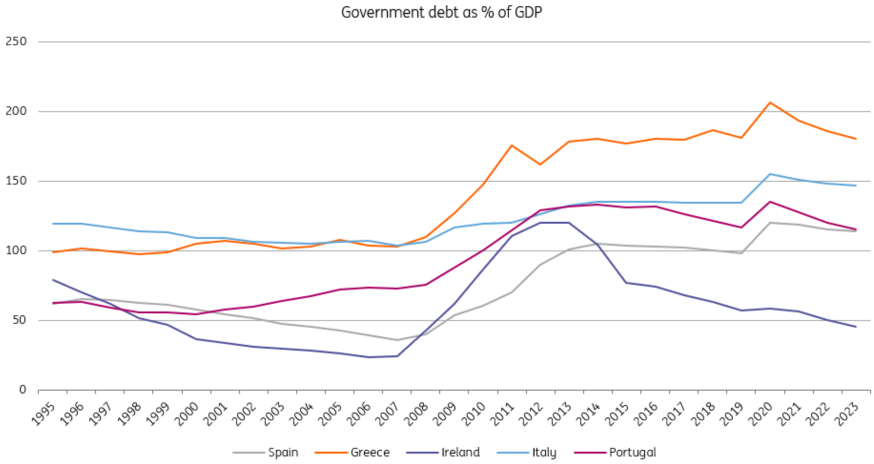
Micheál Martin, the Taoiseach of Ireland

But how are you really doing?

The Irish economy grew by a whopping 10.8% quarter-on-quarter non-annualised in the first quarter of 2022, which is not an exception these days. The large swings in Irish GDP caused by multinational activity paint a thoroughly confusing picture of the economy, that overall seems to be showing more signs of slowing at this point. Modified domestic demand actually shrank in the first quarter, indicating that the domestic economy in Ireland was struggling with high inflation, the coronavirus, and concerns about the Ukraine war – like the rest of the eurozone.

The second quarter did get off to a solid start though and there are few signs that the Irish economy is set for an imminent recession in the short run. Retail sales remained strong at the start of the quarter and unemployment dropped to the lowest level since 2006 at 4.7% in May. The strong labour market underpins solid economic recovery for the time being, although high inflation is clearly eating into Irish domestic purchasing power. Expect decent economic growth to continue in the coming months, but weakness later in the year – spurred by global forces – is set to cause a material slowdown in growth.

Government debt has come down sharply in recent years



Source: European Commission AMECO, ING Research

Debt concerns are small as ECB takes away support

While concerns about a euro crisis are mounting again – which we deem largely overdrawn – Ireland is no longer part of the discussion. In fact, since early 2021, Irish 10-year bonds have been priced similarly to the French, which indicates that it is considered to be among the safer assets in the eurozone. The stress in the bond market seen in the leadup to the ad hoc ECB meeting has therefore largely passed Ireland, as countries like Italy, Spain and Portugal saw spreads with Germany widen much more substantially.

Clearly, much has changed since the euro crisis when it was en vogue to lump Ireland in with the other larger 'eurozone periphery' economies. In fairness, Ireland had always been materially different from the others. Its government debt crisis then was largely caused by the government taking on the debt of its failing banks on the back of a real estate crisis. The economy had always had a strong growth profile and that potential has resulted in a fairly quick economic recovery. Government debt was just 56% of GDP in the fourth quarter of 2021, which is among the lowest in the eurozone. Of course, the radical Irish moves in GDP also related to multinational accounting activity have worked out very favourably for debt sustainability indicators, but all in all, Ireland clearly looks different from the rest of the old periphery now that new debt concerns prevail.

The Irish economy in a nutshell

	2021	2022F	2023F	2024F
GDP (%)	13.5	9	1.3	1.8
Private consumption (%)	5.7	4.8	1.2	2.2
Investment (%)	-37.6	-20.7	3.8	5.1
Government consumption (%)	5.4	1.7	0.1	0
Net trade contribution (%)	25.8	14.5	-0.5	-1
Headline CPI (%)	2.4	8.3	3.5	2.1

Source: ING Research

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Finland: In the eye of the geopolitical storm

Despite all the geopolitical concerns Finland is facing, the economy is still performing quite well. Expect the cost of living problems to result in a...

Finland's Prime Minister Sanna Marin

The war in Ukraine has marked a dramatic shift for Finland at the geopolitical level with the application for NATO membership as the most concrete result so far. The economy is still performing well, but the war in Ukraine and high inflation – not unrelated of course – have dented both business and consumer confidence significantly.

Trade disruptions are smaller than you'd expect

The energy impact on Finland is modest. Finland is not so reliant on Russia as a power source because it gets a large amount of its energy from renewables and nuclear sources. That leaves its dependence on natural gas quite limited – in fact it's only 6% of total energy in Finland, well below the 24% average for the eurozone. That 6% comes largely from Russia though, so the halting of the Russian gas supply in May does not come without consequence. While the Finnish gas supply has remained uninterrupted for the time being, prices have of course been increasing, adding to the purchasing power squeeze that the Finnish economy is experiencing.

In terms of total exports, the Finnish economy has also taken just a modest hit from sanctions on Russia. Yes, nominal exports have fallen to the lowest reading since the late 1990s – so volumes have dropped even more dramatically – but trade with Russia is not huge for Finland anyway. In recent years, exports to Russia made up about 5-6% of total exports, which has currently dropped to 2%. Total exports have continued to grow rapidly though and growth has actually accelerated since March. As total exports remain well above pre-pandemic levels, Finnish competitiveness is performing quite well for the moment and the hit from sanctions on Russia is therefore not visible in the aggregate data.

Sanctions have had a strong effect on exports to Russia

Source: Macrobond, ING Research

Slowdown in the making

Of course, the Finnish economy will not remain unscathed. Finnish central bank governor Olli Rehn recently said that the Eastern Finnish economy, which is directly connected to Russia by land border, is set to experience significant fallout from the conflict in Ukraine. Meanwhile, surging inflation is also impacting the Finnish consumer significantly. Consumer confidence has – in line with most of Europe – plunged to recessionary levels. Businesses are also becoming more pessimistic as both global and domestic demand are set to weaken over the second half of the year.

Still, the Finnish trend output indicator for April showed healthy economic growth at the start of the second quarter. Like the rest of Europe, it looks like the longer-lasting inflation impact on the economy will materialise later, making economic contraction in the second half of the year a strong possibility.

The Finnish economy in a nutshell

	2021	2022F	2023F	2024F
GDP (%)	3.5	2.2	0.3	1.2
Private consumption (%)	3.1	2.3	0.6	1.8
Investment (%)	1.2	1.1	0.7	2.2
Government consumption (%)	3.2	3.4	1	0.5
Net trade contribution (%)	-0.2	-0.4	-0.4	0
Headline CPI (%)	2.1	6.1	2.4	2

Source: ING Research

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