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Eurozone country update

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More accidents on the road to recovery

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Germany needs an 'Agenda 2030'

A stagnating economy, cyclical headwinds and structural challenges bring to mind the early 2000s and call for a new reform agenda

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As Mark Twain is reported to have said, "History doesn't repeat itself, but it often rhymes." Such is the case with the current economic situation in Germany, which looks eerily familiar to that of 20 years ago.

Back then, the country was going through the five stages of grief, or, in an economic context, the five stages of change: denial, anger, bargaining, depression and acceptance. From being called 'The sick man of the euro' by The Economist in 1999 and early 2000s (which created an outcry of denial and anger) to endless discussions and TV debates (which revelled in melancholia and self-pity) to an eventual plan for structural reform in 2003 known as the 'Agenda 2010', introduced by then Chancellor Gerhard Schröder. It took several years before international media outlets were actually applauding the new German Wirtschaftswunder in the 2010s.

It's hard to say which stage Germany is in currently. International competitiveness had already deteriorated before the pandemic but this deterioration has clearly gained further momentum in recent years. Supply chain frictions, the war in Ukraine and the energy crisis have exposed the structural weaknesses of Germany's economic business model, and come on top of already weak digitalisation, crumbling infrastructure and demographic change. These structural challenges are not new but will continue to shape the country's economic outlook, which is already looking troubled in the near term.

Order books have thinned out since the war in Ukraine started, industrial production is still some 5% below pre-pandemic levels and exports are stuttering. The weaker-than-hoped-for rebound after the reopening in China together with a looming slowdown or even recession in the US, and the delayed impact of higher interest rates on real estate, construction and also the broader economy paint a picture of a stagnating economy. A third straight quarter of contraction can no longer be excluded for the second quarter. Even worse, the second half of the year hardly looks any better. Confidence indicators have worsened and hard data are going nowhere. We continue to expect the German economy to remain at a de facto standstill and to slightly shrink this year before staging a meagre growth rebound in 2024.

Headline inflation to come down after the summer

What gives us some hope is the fact that headline inflation should come down more significantly after the summer. Currently, inflation numbers are still blurred by one-off stimulus measures last year. Come September, headline inflation should start to come down quickly and core inflation should follow suit. While this gives consumers some relief, it will take until year-end at least before real wage growth turns positive again. At the same time, an increase in business insolvencies and a tentative worsening in the labour market could easily dent future wage demands and bring back job security as a first priority for employees and unions. In any case, don't forget that dropping headline inflation is not the same as actual falling prices. The loss of purchasing power in the last few years has become structural.

Fiscal and monetary austerity will extend economic stagnation

With the economy on the edge of recession, the government's decision to return to (almost) balanced fiscal budgets next year is a bold move. No doubt, after years of zero and sometimes even negative interest rates, Germany's interest rate bill is increasing and there are good reasons to stick to fiscal sustainability in a country that will increasingly be affected by demographic change (and its fiscal impact). Nevertheless, the last 20 years have not really been a strong argument for pro-cyclical fiscal policies. With both fiscal and monetary policy becoming much more restrictive, the risk is high that the German stagnation will become unnecessarily long.

Waiting for 'Agenda 2030'

In the early 2000s, the trigger for Germany to move into the final stage of change management, 'acceptance' (and solutions), was record-high unemployment. The structural reforms implemented back then were, therefore, mainly aimed at the labour market. At the current juncture, it is hard to see this single trigger point. In fact, a protracted period of de facto stagnation without a severe recession may reduce the sense of urgency among decision-makers and suggests Germany could be stuck in the stages of denial, anger, bargaining and possibly depression for a long time. Two decades ago, it took almost four years for Germany to go through the five stages of change. We hope this time that history will not be repeated.

The German economy in a nutshell (% YoY)

	2022	2023F	2024F	2025F
GDP	1.9	-0.4	0.1	1.3
Private consumption	4.4	-1.8	-0.2	0.2
Investment	0.6	1.5	2.0	3.0
Government consumption	1.2	-2.0	3.0	2,0
Net trade contribution	-0.5	0.3	-1.5	0.5
Headline CPI	8.7	5.9	2.3	2.0
Unemployment rate (%)	3.2	3.4	3.4	3.3
Budget balance as % of GDP	-2.6	-4.7	-1.5	-1.3
Government debt as % of GDP	66	67	61	60

Source: Thomson Reuters, all forecasts ING estimates

French outlook is weak amid social tension

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Against a backdrop of tense social conditions and despite a disinflationary trend that is well underway, the outlook for the French economy remains weak. We forecast 0.5% growth in 2023 and 0.6% in 2024

The strength of demand for tourism-related activities and the high level of bookings for this summer should support French economic activity in the third quarter

The French economy has started the year better than other European countries

In the first few months of 2023, the French economy held up a little better than the other eurozone countries, with GDP rising by 0.2 in the first quarter, after a period of near stagnation in the second half of 2022. After a sharp fall at the end of 2022 against a backdrop of high inflation, household consumption has stabilised, but this stabilisation is partly artificial.

As the government reduced its support for energy consumption, public energy consumption fell, while household energy consumption was recorded as rising, offsetting the sharp fall in food consumption (to its lowest level for 23 years). At the same time, investment fell sharply, weighed down by rising interest rates. The global economic slowdown has also weighed more heavily on French exports.

Tense social climate keeps confidence at a very low level

The first few months of the year were marked by a tense social climate, with numerous demonstrations against pension reform in the spring, followed in the early summer by riots in some localities after a young man was killed by a police officer during a checkpoint. Although the microeconomic impact of these events may be significant for some sectors at the time, the effects are generally offset later. Studies have shown that the macroeconomic impact is generally very limited, removing a maximum of 0.1 or 0.2 points from annual growth.

Nonetheless, these events monopolised attention and probably helped to keep consumer confidence at a historically low level, and the household savings rate well above its long-term average. Against a backdrop of persistently high inflation, rising interest rates and a less expansionary fiscal policy, this is contributing to weak momentum in domestic demand, which is likely to persist over the coming quarters.

Given President Emmanuel Macron's lack of a majority in parliament, a tense and divided social and political context is likely to remain the norm over the next few years and will continue to slow down or prevent the implementation of important reforms. The pension reform, which raises the retirement age from 62 to 64, will come into force in autumn 2023.

Moderate outlook

From a sectoral point of view, the strength of demand for tourism-related activities and the high level of bookings for this summer should support French economic activity in the third quarter, but the support should diminish thereafter. At the same time, the industrial sector is suffering from weakening global demand. According to survey results, business leaders' assessment of order books has remained very weak for several months. At the same time, inventories of finished products remain high. This means that production is likely to decline over the coming months, as companies see no new orders coming in and have to clear their inventories. The PMI indices for the manufacturing sector have been in contraction territory (below 50) since January.

In short, the growth outlook for the French economy is moderate. Growth in the second quarter will be weak, with a fall in GDP remaining a risk. Growth in the third quarter should be slightly better, supported by the good health of the tourism sector, which continues to benefit greatly from the post-pandemic recovery. But this is likely to lose momentum in the fourth quarter, and the end of 2023 and 2024 look weaker, against the backdrop of a global economic slowdown and high interest rates that will have an increasing impact on demand.

We are expecting growth of around 0.5% this year. For 2024, the gradual recovery in household purchasing power thanks to lower inflation is likely to be offset by even weaker global demand. As a result, we are less optimistic than the central banks and are forecasting French GDP growth of 0.6% in 2024 (compared with a forecast of 1% by the Banque de France).

The trend toward disinflation has begun and will continue

Inflation in France stood at 4.3% in June, compared with 5.1% in May, thanks to a fall in energy prices and slower growth in food prices. The fall in inflation is set to continue over the coming months. Growth in producer price indices has slowed markedly. In addition, business price intentions are moderating sharply: price intentions in the manufacturing sector are at their lowest since early 2021, while in the services sector they are at their lowest since November 2021. These figures are in addition to those for the prices of agricultural products, which are falling sharply, which should lead to a sharp fall in food inflation over the coming months.

The trend toward disinflation is therefore clearly underway and will continue. However, this trend will probably be slower in France than in other countries, due to less favourable base effects for energy. The tariff shield and fuel rebates prevented a sharp rise in energy prices over the summer and autumn of 2022. As a result, energy inflation is likely to return to positive territory in France in the coming months, with energy prices for the remainder of 2023 likely to remain higher than their levels in 2022, unlike in other countries. This will probably keep overall inflation higher in France than elsewhere this autumn and at the end of 2023. But this does not change the overall picture: ultimately, although less visible than elsewhere, disinflation is well underway and will continue to be seen in France over the coming months.

While this trend is clearly encouraging, it does not mean that the problem of inflation is completely over. There is still a major risk pocket, namely services inflation, which is likely to increase in the months ahead and will probably become the main contributor to French inflation by the end of the year. The successive increases in the minimum wage, particularly in January and May 2023, which are being passed on to all wages, will continue to push up the price of services. The Banque de France estimates that negotiated pay rises will average 4.4% in 2023 (compared with 2.8% in 2022 and 1.4% in 2021), often supplemented by a one-off bonus. Salary increases are more pronounced in sectors where recruitment difficulties are greatest.

As we expect the labour market to remain tight over the coming quarters despite the economic slowdown, wage increases are likely to strengthen further. However, given the lower price intentions and sluggish demand we expect in the coming quarters, it is likely that wage increases will not be fully passed on to selling prices, weighing on margins. Therefore, inflationary pressures, including in the services sector, should eventually subside. We expect CPI inflation to average 4.6% in 2023 (5.6% for the harmonised index) and 2.1% in 2024 (3.1% for the harmonised index).

The French economy in a nutshell (% YoY)

	2021	2022	2023F	2024F	2025F
Demand and output					
GDP	6.8	2.6	0.5	0.6	1.3
Private consumption	5.3	2.9	-0.4	0.7	1.6
Investment	11.4	2.2	0.1	-0.7	1.5
Government spending	6.3	2.6	0.5	0.6	1.2
Net trade contribution (% points of contribution to GDP)	-0.1	-0.8	0.6	0.3	-0.1
Labour market					
Unemployment rate (% eop, Eurostat)	7.8	7.3	7.2	7.5	7.6
Government finances					
Budget balance as a % of GDP	-6.5	-4.7	-4.9	-4.8	-4.8
Government debt as a % of GDP	114	112	112	113	115
Prices					
Inflation (HCPI)	2.1	5.9	5.6	3.1	2.1

Source: ING research

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The service sector is driving Italy's growth

The weakening in industry temporarily leaves the onus of growth on services. Demand wise, expect consumption to benefit from resilient employment and decelerating inflation. Investments will reflect better progress (or the lack thereof) in the implementation of the European Recovery and Resilience funds

The services sector is helping to drive growth in Italy

First quarter consumption driven by a strong recovery in purchasing power

The surprisingly strong 0.6% quarter-on-quarter GDP growth between January and March this year was driven by domestic demand. The relative strength of consumption was due to a 3.1% quarterly rebound in households' real purchasing power, which benefited from the slowdown in inflation dynamics. The resilient labour market, with employment up and unemployment and inactivity down on the quarter, was apparently a decisive factor. Conditions were there for households' saving ratio to reach 7.6% (from 5.3% in the fourth quarter of 2022), close to the pre-Covid 8% average, without penalising consumption.

Weakening industry points to softer growth in the second quarter

Data for the second quarter suggests that the very good performance of the first will be hard to replicate. Industry just managed to propel value-added in the first quarter, but this seems highly unlikely in the second after a very disappointing -1.9% industrial production reading in April.

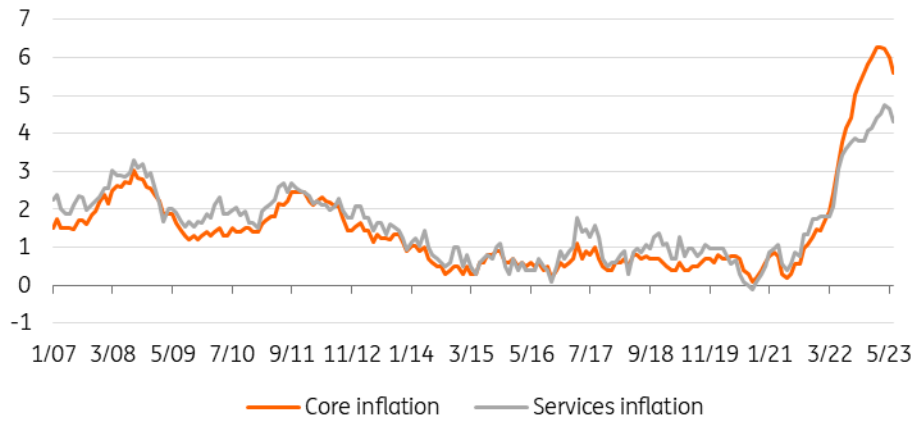
Business confidence data for May and June and the relevant PMIs point to manufacturing softness through the rest of the second quarter and, possibly, into the third. For the time being, the decline in gas prices has failed to provide any relevant supply push for manufacturers, outweighed by deteriorating order books and stable stocks of finished goods. Services are also signalling some fatigue, but still look to be a decent growth driver, helped by a strong summer tourism season.

The fall in producer prices will bring goods disinflation down the line in CPI

The flipside of industrial weakness is a sharp deceleration in producer price dynamics. Courtesy of declining energy prices, PPI inflation entered negative territory in April, anticipating further decelerations down the line in the goods component of headline inflation.

Services inflation is proving relatively stickier, though, possibly reflecting in part a re-composition of consumption patterns out of interest rate-sensitive durable goods into services as part of the last bout of the re-opening effect. With administrative initiatives on energy bills still in place at least until the end of the summer, and with big energy base effects yet to play out, the CPI disinflation profile is still exposed to temporary jumps, but the direction seems unambiguously set.

Stickier services inflation to slow the decline in core inflation



Source: Refinitiv Datastream

Resilient labour market to continue to support consumption

A declining inflation environment will likely coexist with a resilient employment environment, at least in the short term. Labour market data continue to point to residual job creation, with a prevalence of open-ended contracts over temporary ones. This is clearly helping to support consumer confidence and keep concerns about future unemployment at low levels.

Unfavourable demographics and supply-demand mismatches could keep some pressure on wages, at least in certain sectors. For the time being, the impact on aggregate hourly wages has been limited (in May it was up by 2.4% year-on-year), but we can't rule out it inching up to the 3% area towards the end of the year.

All in all, the combined effect of decelerating inflation, resilient employment and slowly accelerating wages should continue to support real disposable income, ultimately creating room for decent consumption growth in 2023.

Investment at least temporarily affected by a slowdown in the RRF implementation

In the current circumstances, the area more exposed to temporary hiccups is investment. According to the April bank lending survey (BLS), in the first quarter the general level of interest rates was acting as the most powerful drag on borrowing activity, with businesses needing to fund inventories and working capital more than new investments.

A potential counterbalance might come from the push on investments coming from the European Recovery and Resilience Facility (RRF). A delay in the disbursement of the third tranche, due last January, is possibly causing some concerns, inducing extra prudence. However, a quick solution to the current impasse and, even more relevant, the much-awaited disclosure by the Italian government of its revised plan, could give businesses more visibility on viable projects and potentially revitalise investment action.

The pending ratification by Italy of the European Stability Mechanism reform remains a source of friction in the relationship with the European Union. Prime Minister Giorgia Meloni's claim to make it part of a comprehensive deal encompassing the revision of the RRF plan and the reform of the Stability and Growth Pact seems a bit illusory and overly ambitious. A piecemeal approach would have likely allowed the Italian government to have a better say in the reform of the Stability and Growth Pact, which will be finalised by year-end.

All in all, we expect that the Italian economy will manage to post marginally positive growth in the middle quarters of 2023, mainly thanks to services. If that is the case, building on the strong carryover effect of the first quarter, then an average GDP growth of 1.2% in 2023 seems a reasonable base case call.

The Italian economy in a nutshell (% YoY)

	2022	2023F	2024F	2025F
GDP	3.8	1.2	0.8	1.1
Private consumption	4.6	1.1	0.6	1.0
Investment	9.6	2.4	0.9	1.3
Government consumption	0.0	0.8	0.1	0.4
Net trade contribution	-0.5	0.3	-0.4	0.1
Headline CPI	8.7	6.5	2.3	2.1
Unemployment rate (%))	8.1	8.0	8.1	7.9
Budget balance as % of GDP	-8.0	-5.1	-4.3	-3.5
Government debt as % of GDP	144.4	141.6	141.7	141.5

Source: Refinitiv Datastream, all forecasts ING estimates

Low growth after a technical recession in the Netherlands

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Dutch GDP is stagnating, with weak growth expectations of 0.3% for 2023. We forecast a technical recession for the first half of this year, followed by subdued growth during the rest of 2023 and 2024. Inflation is high but is expected to come down, providing some room for real income growth which should help household consumption

We expect weak growth in the Netherlands for the rest of the year following a technical recession in the first half of the year

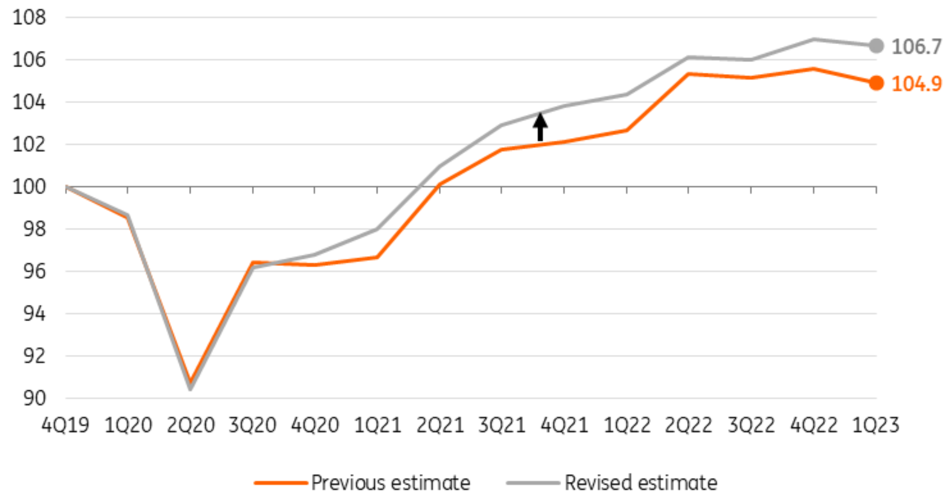
Covid recovery even stronger than originally estimated thanks to a stronger current account

National accounts data for the Netherlands were revised considerably, partially changing the narrative of the Covid experience for the Dutch economy. While the Covid trough in GDP in the second quarter of 2020 was a bit deeper than initially thought, GDP has been revised significantly upward. The quarterly figures for 2021, in particular, were revised higher, resulting in a GDP level in the first quarter of 2023 that was 1.7% higher than previously estimated. International trade was revised upwards strongly. The goods trade balance was an important contributor to the GDP revision. Consumption by households and inventories was also revised upwards, while public consumption was revised down a little.

The revisions made the contraction at the start of this year appear more modest: the quarter-on-quarter growth rate for the first quarter was revised from -0.7% seasonally adjusted to -0.3%. All this means that GDP was 6.7% higher in the first quarter of 2023 than in the fourth quarter of 2019, just before the pandemic. This makes the GDP development of the Netherlands since the start of the pandemic stand out even more in comparison to its peers. In addition, gross national income was revised strongly due to upward revisions of the balance of primary income. This was mostly the result of large upwards revisions of (retained) profits of listed companies.

Large upward revision of Dutch GDP figure

Gross domestic product of the Netherlands*, index 4th quarter of 2019 = 100



*Seasonally adjusted and in constant prices

Source: CBS, calculations ING Research

Very weak start to the second quarter is likely to result in a technical recession

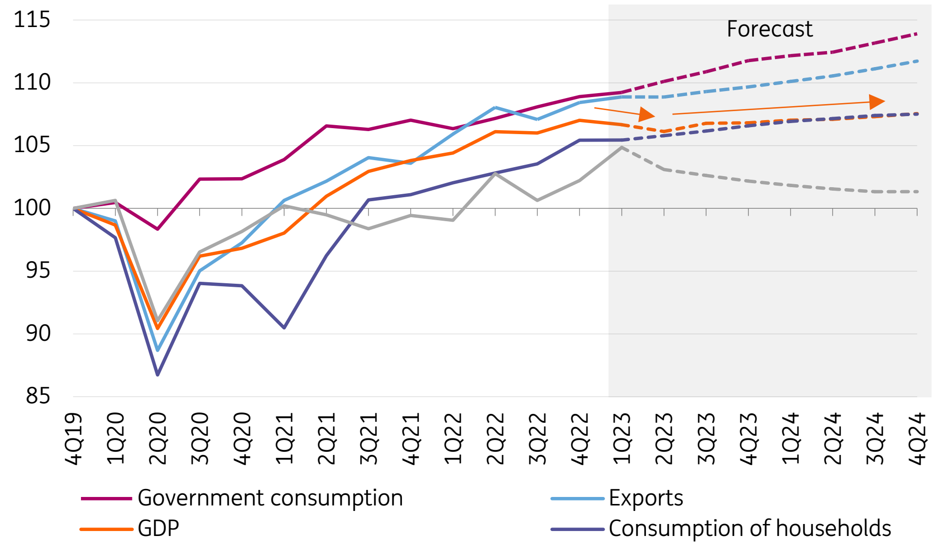
All else being equal, the revisions would have boosted the Netherlands' annual GDP growth forecast for 2023. However, we revise it slightly downwards to 0.3% quarter-on-quarter due to the very weak data that we observe for the start of the second quarter. The hard (seasonally adjusted) data for April and May on a month-on-month basis was especially disappointing:

- Construction production contracted by -5.3% MoM in April.
- Manufacturing production contracted by -3.9% MoM in April, while rising only 1.9% in May.
- Retail sales excluding motor vehicles (Eurostat definition) stagnated at 0.1% MoM both in April and May, while retail sales also excluding gas stations and pharmacies (Statistics Netherlands definition) contracted by -0.1% MoM in April and -1.4% in May.
- Gross capital formation on fixed assets contracted -2.9% MoM in April.
- Goods imports rose 7.2% MoM in April (to some degree due to the propping up of gas storage).
- Goods exports contracted -0.5% MoM in April.
- Domestic consumption stagnated at 0.0% MoM in April and expanded by 1.0% in May, being a positive outlier so far.
- Prices of existing homes fell -1.0% MoM in April and -0.6% in May.

At the same time, sentiment data worsened in April, May and June. Also, we expect the inventory reduction cycle to continue in the second quarter, albeit at a lower rate than in the first quarter, since firms still consider their inventory levels as too high. All in all, our second quarter GDP forecast is a contraction of -0.5% QoQ. This implies a technical recession in the first half of 2023.

Technical recession and then weak growth

Expenditures*, index 4th quarter of 2019 = 100



*Seasonally adjusted and in constant prices

Source: Macrobond, forecasts ING Research from 2Q23

Second half growth is expected to be too weak for a decent growth rate for 2023

The technical recession will, in our view, be followed by weak growth. Investment is expected to be the main drag on growth during the remainder of the year, as higher funding costs and weak sales expectations kick in. GDP growth in the second half of 2023 needs to come from the expansion of service consumption by households, higher service exports due to a further rebound of inbound tourism (especially in the third quarter) and public expenditures. We also forecast goods exports to pick up again, but only sluggishly. Public expenditures are assumed to rise a bit less than initially anticipated, due to the recent fall of the government: this is likely to put a stop to the execution of a number of policy plans.

Consumption of households so far has held up well during the energy crisis, even though the Netherlands also experienced a terms of trade loss due to the high prices of imported gas and therefore the loss of consumer purchasing power. Very strong employment growth (+6.4% compared to pre-pandemic) and high net nominal income growth for lower-income households (who have a high marginal propensity to consume) explain why.

As inflation is coming down in the second half of 2023 while wage increases remain high, consumption of households is forecast to continue its (mild) growth, even though employment growth will not be as strong as in the past. Saving rates are coming down from still elevated levels, also providing support for consumption development to remain decent. Despite this support for consumption, GDP is forecast to expand by only 0.3% for the full year 2023, adjusted for working days.

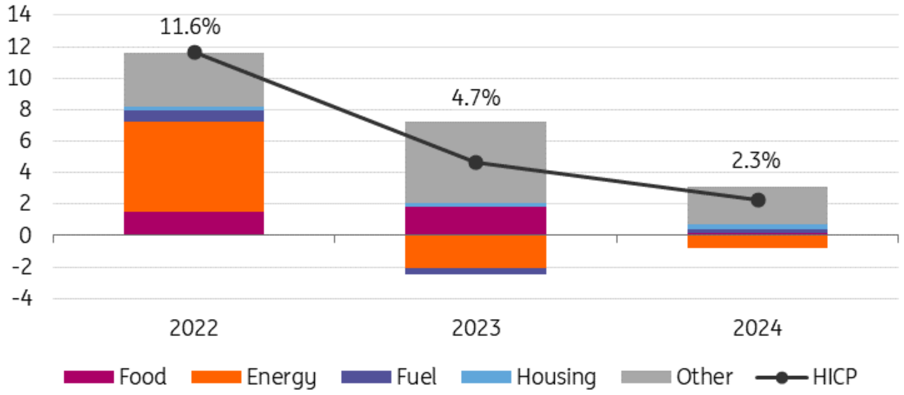
Inflation is falling in 2023 thanks to energy base effects

Although lower than the inflation rate of 11.6% in 2022, our forecast for 2023 is still at a high of 4.7%. Food and bars and restaurants are important contributors to the higher price level in 2023. Yet, inflation has been falling throughout the year. Headline consumer price inflation fell recently, from 6.8% YoY (HICP) in May to 6.4% in June. Core inflation (inflation excluding volatile items like energy and food) came down from 8.2% in May to (a still high) 7.1% in June. The deceleration in June was due to services and fuel, industrial goods and food, beverages and tobacco.

For energy and fuel, the fall in prices was smaller than in May due to statistical base effects, i.e. due to movements in the price level in 2022: the month-on-month changes in June 2023 were slightly negative. Such base effects for energy will be the main reason why we project the headline year-on-year inflation rate to move close to 2% in the last quarter of 2023.

Inflation falling with large negative energy base effects

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



Source: Macrobond, forecasts as of 2023 by ING Research

Firms signal lower selling price inflation

We see overall inflation pressures falling in the near future: selling price expectations of businesses for the next three months fell for the eighth month in a row in June. There is one major exception: services. Inflation of services is not forecast to decelerate as quickly as for food and industrial goods. For now, we are working with the assumption of wages decelerating in 2024 compared to the high numbers (of around 6% for bargained wages) of 2023. The forecast for headline inflation to fall to 2.3% in 2024 depends on that assumption. This scenario has become more likely now that demand for personnel from the public sector might slow a bit, as the government is adopting a caretaker mode for many months to come.

New method for measuring energy inflation distorts headline picture

June was the first month in which Statistics Netherlands (CBS) used a new method for measuring energy inflation. While it used to only look at the prices of new contracts, it is now also taking existing (fixed-term) contracts into account. If this new method was used in the past, the 2022 inflation rate would have been a lot (i.e. more than 3%) lower than actually recorded, while for 2023 the rate of change would be much higher than observed now.

Since Statistics Netherlands is not legally allowed to revise historical inflation figures, this means that all year-on-year inflation rates are somewhat distorted. As of June 2024, this issue is gone. Fortunately, the price levels of the old and new methods have been already quite similar in recent months. As such, the introduction of the new method had only limited effects on our recent forecasts.

The Dutch economy in a nutshell (% YoY)

	2022	2023F	2024F	2025F
GDP	4.3	0.3	1.3	1.1
Private consumption	6.5	2.1	1.5	0.7
Investment	1.8	2.4	-2.2	0.6
Government consumption	1.6	2.5	2.4	2.4
Net trade contribution (%-point)	1.0	-0.6	-0.4	0.0
Headline HICP	11.6	4.7	2.0	1.6
Unemployment rate (%)	3.5	3.6	4.0	4.2
Budget balance (% of GDP)	-0.1	-2.2	-2.8	-2.9
Government debt (% of GDP)	50.1	48.7	50.0	52.2

Source: Macrobond, all forecasts ING Research estimates

Spanish elections unlikely to hamper growth outlook

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The outcome of the Spanish elections could lead to changes in economic policy. However, the reactivation of European fiscal rules in 2024 limits the extent to which fiscal policy can be adjusted, limiting the risk to our growth outlook

Continued growth in the tourism sector will be the main driver of Spain's higher growth rates.

Uncertainty surrounding Spanish elections

Following major losses in the recent regional and local elections on 28 May, Prime Minister Pedro Sanchez of the Socialist Workers' Party (PSOE) has called for early elections in Spain. Although the latest polls indicate a shift to the right side of the political spectrum, the outcome of the upcoming elections remains uncertain. If the polls are correct, the conservative People's Party (Partido Popular) will get the most votes, but not the majority to form a government. In such a scenario, the third-largest party, the far-right Vox, will play a decisive role in forming a government.

As elections approach in Spain, the political landscape is characterised by high fragmentation and polarisation. Over the past decade, the Spanish political landscape has undergone a significant transformation, with a remarkable increase in the number of parties. This fragmentation has led to greater instability as coalition governments must now be formed, which often rely on a fragile consensus. Based on the latest polls, it seems likely that another coalition government will have to be formed.

How the Spanish election could affect the economic outlook

Spain's economy has outperformed that of other eurozone countries over the past year, but is still weighed down by structural weaknesses such as high debt, low productivity and a rigid labour market. Despite a historically low unemployment rate, it is still among the highest in the eurozone and youth unemployment is alarmingly high. Moreover, the country has still not fully recovered from the pandemic, despite last year's impressive growth figures.

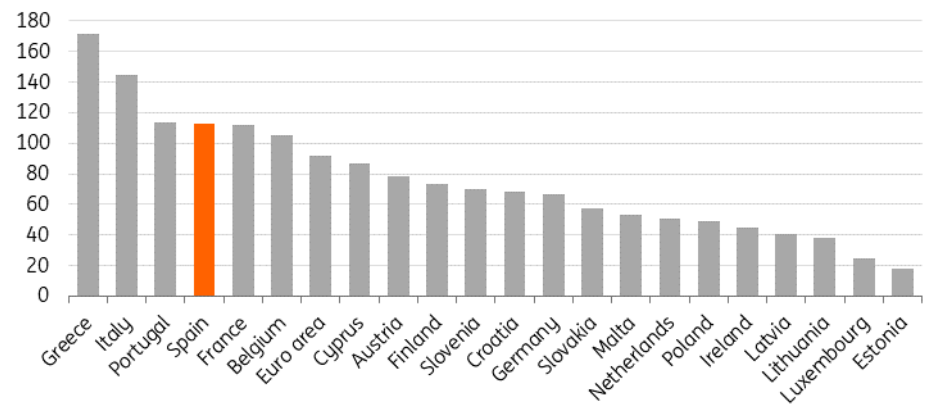
The elections could also be the starting point of a longer period of political instability, although this is not our baseline scenario. This could happen if the election results make it difficult to form a stable majority, leading to protracted government negotiations. In addition, there is still a real possibility that a clear majority cannot be formed, which would lead to a hung parliament necessitating new elections and prolonging political uncertainty. In such a scenario, crucial structural reforms needed for the economy may be delayed, reinforcing existing weaknesses. Persistent uncertainty about future government policies could also undermine investor confidence and hamper investment activities.

If a new right-wing government comes to power, it could bring about a change of course in economic policy. Conservative leader Feijóo has already announced plans for more business-friendly policies and tax cuts, including a proposed income tax cut for people earning less than €40,000 a year. There is also a real chance that the planned closure of nuclear power plants in 2027 will be postponed to secure energy supplies. The extent of these policy shifts will depend on the consensus among coalition partners and the strength of their majority. If the right-wing Conservatives and Vox form a comfortable majority, they will feel more supported to reverse certain previous government policies.

Despite a possible change of direction in economic policy, there is little room to shift to a more stimulative fiscal policy. Spain's public debt ratio is one of the highest in the eurozone at 113.2%. Spain ranks below Greece (171.3%), Italy (144.4%) and Portugal (113.9%). According to current forecasts, Spain will overtake Portugal in the ranking this year. This shift is due to a lower expected government deficit in Portugal combined with slightly better growth prospects.

Spain recorded a deficit of 4.8% of GDP in 2022, and both our forecast and that of the Bank of Spain suggest that the deficit will remain above the 3% threshold at least until 2025. This level is considered an excessive deficit by the European Commission. The reactivation of European fiscal rules in 2024 will increase pressure on fiscal consolidation measures. Regardless of the election outcome, addressing public finances will be inevitable, further limiting the government's flexibility to pursue more expansionary fiscal policies.

Government debt to GDP ratio, 2022



Source: Eurostat

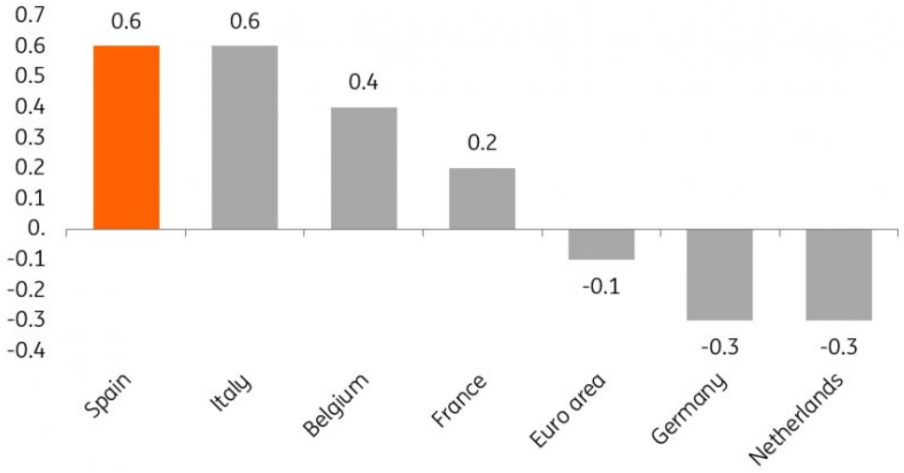
New government will take office amid a slowing economy

Spain's economy was the fastest-growing of all larger eurozone countries in the first quarter, growing 0.6% quarter-on-quarter. Like other southern countries, Spain benefited from growth in net exports driven by a continued rebound in tourism. In addition, the Spanish economy benefited from some structural differences, such as a relatively smaller industrial sector compared to, for instance, Germany. It is precisely this energy-intensive industry that has suffered the most from higher energy prices and tightening financial conditions. Finally, Spanish energy prices, partly due to the introduction of the gas price cap, have not risen as much as in several other countries.

Despite the good start, maintaining this positive momentum may be challenging. Although several factors such as a pick-up in wages, improvements in global supply chains, falling energy prices, and government support packages are giving some tailwind, the tightening of financial conditions will increasingly cast a shadow on the economy. It is hard to imagine that the rapid and significant increase in policy interest rates will not significantly slow economic growth.

The external environment is also expected to weaken further, with the eurozone experiencing a technical recession over the past two quarters, China's economic recovery falling short of expectations and US growth expected to slow. This could also affect Spain's tourism sector. A slowdown in the global economy could lead to less international travel, limiting the growth of the tourism sector in 2024.

Spain recorded the strongest growth among larger euro countries in the first quarter



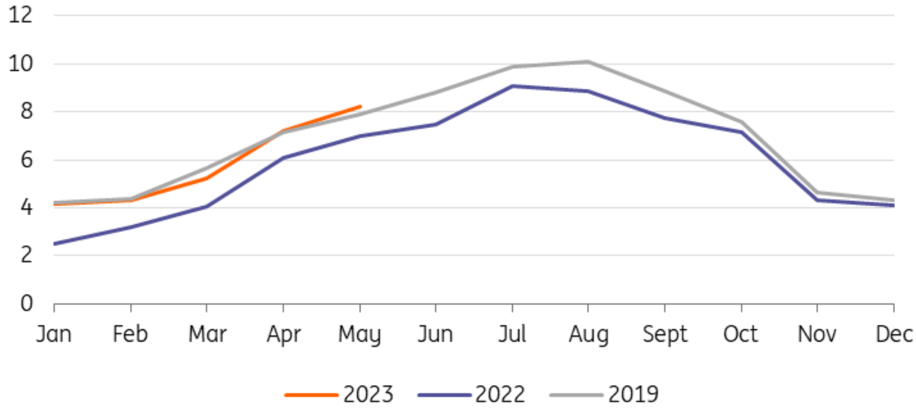
Source: Eurostat

Tourism will be the main growth driver this year

The slowdown in the Spanish economy can be attributed to the overall deceleration of the global economy. Nevertheless, Spain is poised to become the best-performing economy among the larger eurozone countries this year. We forecast average growth of 2.2% for Spain this year, well above the eurozone average of 0.4%.

Continued growth in the tourism sector will be the main driver of Spain's higher growth rates. Although the number of international tourists entering Spain in 2022 was still 14% below pre-pandemic levels, the gap may be closing this year. In May, the number of international visitors had already risen to 104% of the pre-pandemic level, compared with 88% in May 2022. Strong travel demand points to a promising tourist season ahead. Contributing about 15% to GDP, the tourism sector will remain one of the main catalysts for economic growth throughout the year.

The number of foreign tourists increased above pre-Covid levels in April and May (in millions)



Source: INE

Spanish headline inflation reaches 1.9%

Spanish inflation has fallen faster than in other eurozone countries. In June, Spanish inflation stood at 1.9% year-on-year, while the eurozone recorded 5.5%. These positive developments can be attributed to more favourable base effects from energy prices, which rose faster in Spain than in other countries last year. However, if these favourable base effects fade in the coming months, Spanish headline inflation could rise again. In addition, the phasing out of several government measures by early 2024 is expected to have an upward effect on inflation.

Spanish core inflation, excluding energy and food prices, remains remarkably high at 5.9% and is even above the eurozone average of 5.4%. Core inflation is expected to remain at a high level throughout the year and gradually decline. Yet there are indications that core inflation is also on a sustained downward trend. For instance, inflation in the buoyant hospitality sector, which accounts for 14% of the inflation basket, is cooling markedly despite strong sustained demand on the back of a strong tourist season. Core inflation is expected to remain at high levels throughout the year and only gradually decline.

Slowing momentum despite tourism recovery

For 2023, we expect growth of 2.2%, well above the eurozone average of 0.4%. Although the economy performed strongly in the first quarter, momentum is expected to wane as financial conditions tighten. The main driver of growth will be net exports, supported by the continued recovery of the tourism sector, which surpassed pre-pandemic levels in May and April. Although headline inflation fell to 1.9% in June, it is expected to rise in the coming months due to less favourable base effects for energy and persistent core inflation.

The Spanish economy in a nutshell (% YoY)

	2022	2023F	2024F	2025F
GDP	5.5	2.2	1.0	1.9
Private Consumption	4.4	0.1	2.1	2.1
Investment	4.6	1.5	2.1	2.3
Government consumption	-0.7	0.6	0.7	1.3
Exports	14.4	7.1	1.5	2.7
Imports	7.9	3.4	3.9	3.0
Headline CPI	8.4	3.6	2.7	2.1
Unemployment rate (%)	12.9	13.1	13.3	12.9
Budget balance as a % of GDP	-4.8	-4.1	-3.7	-3.4
Government debt as a % of GDP	113.2	109.8	109.1	108.6

Source: ING research

Trying to ride the election wave in Greece

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Transitioning the economy into the new normal and maintaining a good growth pace won't be easy, but we expect Greece to remain a growth outperformer in the eurozone for at least a couple of years

Greek PM Mitsotakis was elected to a second term and is looking to benefit from the economic recovery and tourism-related services

Mitsotakis has managed to get a second consecutive mandate

It took two election rounds for Prime Minister Kyriakos Mitsotakis, the leader of New Democracy, to obtain a second mandate. In the first round, held on 25 May, he came first but could not obtain an absolute majority due to the proportional system, deprived of the majority bonus. As it was already known that the next election would be held with a different system, reintroducing a majority bonus, outgoing PM Mitsotakis abstained from seeking any form of coalition and focused on the new election, which was held on 25 June.

The different system did the trick. ND broadly replicated the result of May's vote, but this time round, thanks to the bonus, this was enough to obtain 158 seats, out of a required majority of 151. Mitsotakis was again given the mandate to form a government which has assured him another four years in power.

Confronted by a very poor result which saw the number of votes almost halve from the 2016 election result, Alexis Tsipras, the leader of the main opposition party Syriza, resigned.

Two oppositions

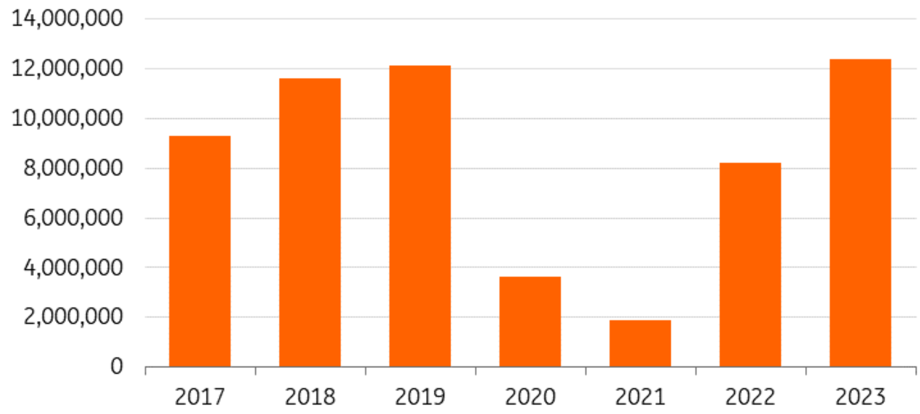
The June election added a new feature to the Greek political scene: three small parties on the right of New Democracy managed to pass the 3% hurdle, obtaining parliamentary representation. This means Mitsotakis will now have to confront two oppositions: one on the left, which will likely need some time to reorganise after the heavy defeat of Syriza, and one on the right, which might prove to be more insidious in its desire for visibility. It will be interesting to see whether pressure from the right will impact the policy line of the government any time soon.

Economy is still enjoying post-pandemic re-opening inertia

The Greek economy has benefited from the post-pandemic period of the prolonged re-opening effect and of the related demand for tourism services. The tourism catch-up still seems to be in place: year-to-date, the number of arrivals has already reached above the levels of 2019 over the same period.

The economic rebound of 2022 has brought about improvements in the labour market which continue to this day. In May, the unemployment rate fell below 11% for the first time since late 2009. Employment gains, helped by cooling inflation, have continued to propel disposable income, ultimately supporting consumption.

Tourist arrivals back above pre-Covid levels (January-May)



Source: Eurostat, ING computations

Keeping up the recovery pace won't be easy

Mitsotakis' second legislature will be a challenging one. The election result very likely reflected a call for continuity from the electorate, particularly in the economic domain. Securing continuity in growth against a backdrop of normalising monetary and fiscal policies will not be an easy task.

A stable return to amply positive interest rates might complicate things on the private investment front, where Greece has yet to fill an investment gap since the times of the sovereign debt crisis. Here, keeping a strong focus on the implementation of the recovery and resilience plan might prove decisive.

On the fiscal front, as elsewhere, the restoration of fiscal rules in 2024 will reintroduce constraints that had disappeared over the recent crisis years. The good news is that Mitsotakis is having his second term in office at the height of the summer tourism season, which is a good start.

Returning Greece to investment grade an obvious target

Looking ahead, an obvious priority for Mitsotakis will likely be to bring Greece back into the investment-grade domain. With a possible new normal characterised by higher rates and restored fiscal discipline, rating agencies might wait for more reassuring evidence about future debt sustainability before pulling the trigger. Developments in state sector accounts until May point to a primary surplus already this year; this is a good starting point, but the resumption of the reform path, temporarily set aside over the pandemic/energy crisis years, will likely be as important to the eyes of the agencies.

In the parliamentary debate, which culminated in a positive vote of confidence for his government, Mitsotakis talked about the plan for the next four years as a multi-dimensional reform. Time will tell.

We expect Greece to remain a growth outperformer in the eurozone for at least a couple of years. For 2023, we project GDP growth of 1.7% year-on-year, with upside risks if the disinflation path proves faster than we are currently projecting.

The Greek economy in a nutshell (% YoY)

	2022	2023F	2024F	2025F
GDP	6.0	1.7	1.6	1.7
Private consumption	7.9	3.3	1.4	1.4
Investment	11.6	7.1	4.8	4.1
Government consumption	-1.5	1.7	0.4	0.4
Net trade contribution	-2.8	2.3	-0.5	-0.2
Headline CPI	9.3	3.7	2.0	2.0
Unemployment rate (%)	12.4	10.8	11	10.9
Budget balance as % of GDP	-2.3	-1.8	-1.0	-0.8
Government debt as % of GDP	171.3	165.4	160.6	156.5

Source: Refinitiv Datastream, all forecasts ING estimates

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Nothing comes for free in Belgium

Solid household consumption is keeping the Belgian economy afloat, but a loss of competitiveness accompanied by worsening public finances and political hurdles will likely weigh on future growth

Solid consumer spending

The sharp rise in energy prices through to autumn 2022 and fall in prices thereafter raised fears of a V-shaped recession, particularly for household consumption. This, however, was not the case in Belgium. On the contrary, household consumption remained very solid throughout the period, even when energy bills hit consumer budgets the hardest. Household consumption has actually remained the main driver of economic growth over the last four quarters, as shown in the first chart below. There are several reasons for this:

1. **Labour market strength**

   First, the labour market remains very solid, despite slowing economic growth in the last quarter of 2022. 75,000 jobs were created in 2022 and 11,500 in the first quarter of this year alone. Job creation has therefore become a key driver in supporting both household income and consumption.

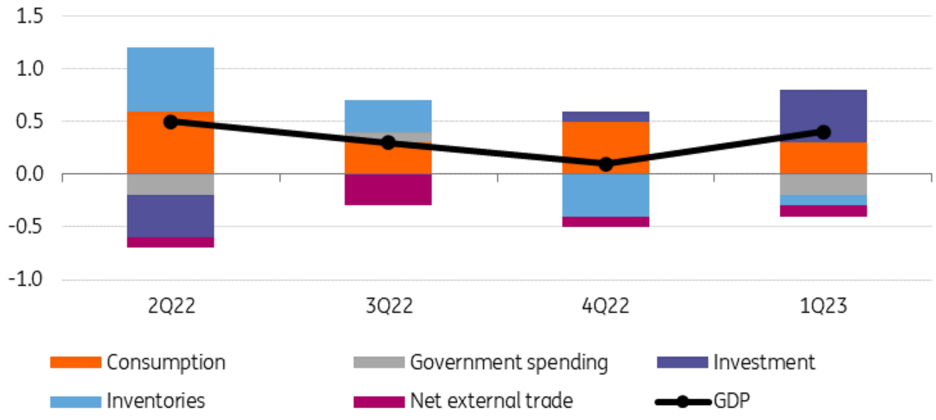
2. **Automatic wage indexation**

   Second, automatic wage indexation has remained in place and has resulted in a nominal increase in wages of at least 10%. It should be noted that, depending on the sector, the indexation mechanism comes into play at different times. A large number of workers, for example, saw their nominal wages increase by more than 11% at the start of 2023. It should also be noted that indexation applies to pensions and all social benefits too.

3. **Government support measures**

   Third, significant additional measures have been taken by the authorities to soften the impact of rising energy prices on household bills – including the first few months of 2023, when gas and electricity prices were falling sharply.

Consumption remains the main support for GDP growth



Source: NBB, calculation: ING

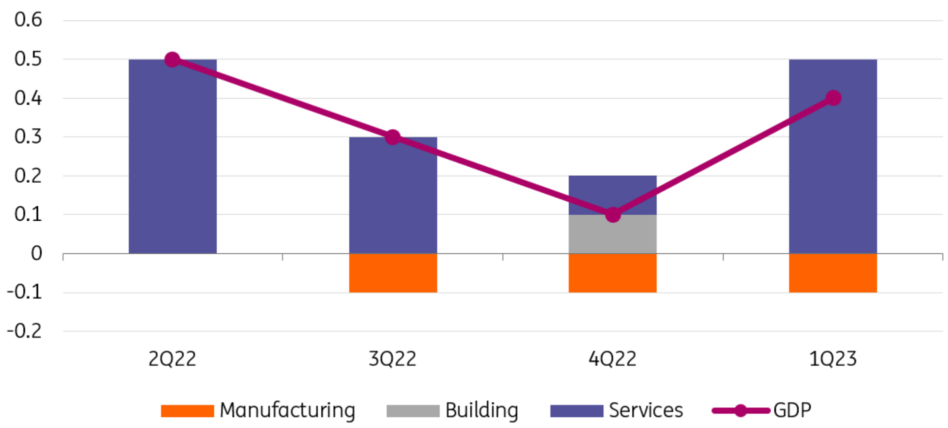
Firing on all cylinders? Not quite

In addition to household consumption, investment has remained volatile and has been impacted by a few large transactions in the shipbuilding industry. This largely explains the solid growth seen in the first quarter of this year. On the contrary, the contribution of net foreign trade to growth remains negative. This can be explained by imports holding up well on the back of solid domestic demand while the export sector copes with weak foreign demand and is also reflected on the supply side by the prolonged contraction in manufacturing activity (as detailed in the graph below). In short, the Belgian economy is not currently performing at its peak level. On the demand side, domestic demand alone is fuelling growth. On the supply side, only the services sector is still showing signs of growth as industry remains in recession.

We should also point out that the ECB's restrictive monetary policy is weighing on household investment in housing, which fell by no less than 4.2% year-on-year in the first quarter of 2023. Nevertheless, activity in the construction sector continues to grow (+2.2% in the first quarter of this year), thanks to other developments in conversion, non-residential buildings and infrastructure.

Manufacturing sector in recession

Quarterly GDP growth decomposition, supply side



Source: NBB, calculation: ING

Threat to competitiveness

The fact that the Belgian economy has a less volatile cycle than the eurozone average is nothing new. As we are currently seeing, growth is more resilient in periods of economic weakness. Unfortunately, this is also accompanied by a lack of vigour throughout periods of recovery. In addition to factors currently impacting the eurozone economy as a whole (weakness in global industry, restrictive monetary policy), two key concerns are mounting in Belgium's case. These concerns are nothing more than the other side of the coin of the elements currently underpinning the solidity of the Belgian economy, but they could have a negative and lasting impact on growth.

Firstly, economic developments in recent quarters have led to a loss of competitiveness for the Belgian economy. The automatic indexation of wages has meant that they have risen faster in Belgium than in neighbouring countries. Negotiated nominal wage increases this year could narrow the gap between these countries and Belgium, but they will not fully compensate for it.

While the strength of the labour market is a good thing for the economy and the improved financial health of households, it is also currently translating into a decline in productivity. On the one hand, there are negative productivity gains within certain sectors. This is particularly evident within the manufacturing sector, where employment grew by 0.8% between March 2022 and March this year, while the sector's value added fell by 2.4%.

On the other hand, we're seeing a composition effect on productivity. A large number of jobs are being created in low-productivity sectors (leisure, healthcare, public sector), while fewer jobs are being created in high-productivity sectors – some of which are even losing jobs (the financial sector, for example). Since productivity is an essential factor in the competitiveness of an economy, recent trends are jeopardising the Belgian export sector's ability to maintain its market share.

Ambitions scaled back

Secondly, while growth in activity is fuelling tax receipts, Belgian public finances continue to create problems. The measures taken to support households and businesses in recent years have weighed heavily on public finances and so far have not been offset. Given the deterioration in public finances, the government will have to take the first steps towards fiscal consolidation in order to comply with the requirements of the European Commission. However, with just one year to go before the elections and given that the coalition in place brings together parties that are opposed in socio-economic terms, coming up with clear and effective measures will likely prove a challenge.

Even so, we believe that consolidation will have to take place sooner or later. Most of the effort will probably be made after the elections and will follow the formation of a new majority, which is likely to weigh on the dynamics of the economy over the next few years.

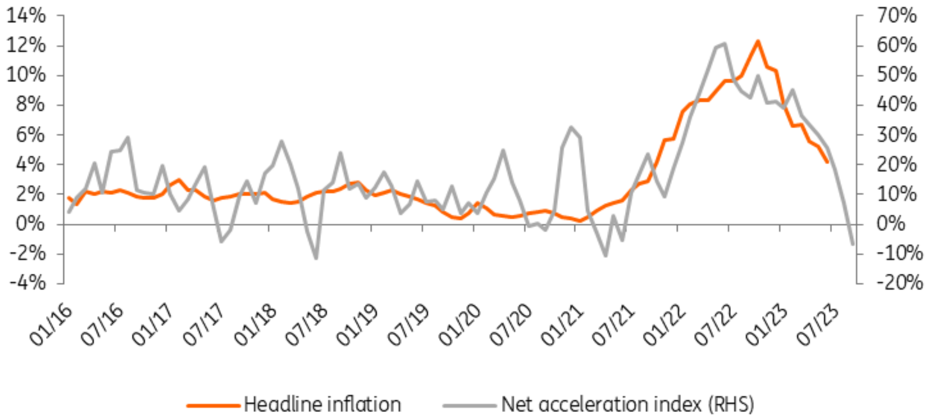
On top of this, the federal government had originally planned to carry out two major structural reforms (pensions and fiscal). A pension reform was agreed at the beginning of July, but political hurdles have greatly reduced the initial ambitions included in the final agreement. In a nutshell, there will be an incentive to keep employees at work longer, and at the same time, the highest additional pension schemes will be required to contribute more to the legal pension system. This should satisfy the European Commission, which requested certain measures before releasing funds from the Recovery and Resilience Facility (RRF).

This agreement is certainly not the major structural reform that was announced. Moreover, it's becoming increasingly clear that the tax reform will not be achieved. Instead, it will be left to the next legislature, which once again limits the ability of the current majority to put public finances back on a sustainable track.

Further decline in inflation story

Inflation peaked at 12.3% in October 2022, and fell back to 4.2% in June, thanks mainly to lower energy prices (gas bills down by almost 64% YoY, and electricity bills down by more than 29%). We're now also seeing signs of easing in other areas – and particularly for food products. Overall, our leading inflation indicator (Net Acceleration Inflation Index – see chart below) tends to show that inflation should continue to fall over the coming months. This indicator uses all the categories of goods and services that are included in the consumer price index in order to determine whether upward pressure on inflation is broad-based or not. In June, the proportion of the consumer price index in a deceleration phase now far exceeds the proportion in an acceleration phase, which is a strong sign that the bulk of the inflation wave is behind us.

Leading indicator shows further decline in inflation



Source: Statbel, computation: ING

The Belgian economy in a nutshell (% YoY)

Note: the net acceleration index is calculated as the share of the CPI with lower inflation in t compared to t-1 minus the share with higher inflation. The shares are calculated on the basis of the weights of each item in the index. The net acceleration indicator is then taken as a three-month moving average.

	2021	2022	2023F	2024F	2025F
GDP	6.3	3.2	1.0	0.7	1.4
Private consumption	5.5	4.1	2.1	0.7	1.2
Investment	5.1	-0.8	0.7	0.5	1.6
Government consumption	5	3.1	-0.5	1.0	1.6
Net trade contribution	0.7	0.4	-0.7	-0.2	0.0
Headline CPI	2.4	9.6	4.6	2.2	2.1
Unemployment rate (%)	6.3	5.6	5.9	5.8	5.7
Budget balance as % of GDP	-5.6	-3.9	-4.3	-4.9	-5
Government debt as % of GDP	109.2	103.2	102.6	104.8	107.5

Thomson Reuters, all forecasts ING estimates

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Sticky inflation hurts Austria's competitiveness

While other eurozone countries are recording significant declines in headline inflation, the downward trend in Austrian inflation is, optimistically speaking, sluggish. This decreases Austria's attractiveness, both in terms of industry and tourism, and will ultimately lead to a decline in the country's competitiveness

Better than expected, but far from good

After the first flash estimates indicated that the Austrian economy had contracted slightly by 0.3% quarter-on-quarter in the first quarter of 2023, the final revision revealed a small increase of 0.1% quarter-on-quarter, which could be considered stagnation rather than growth. While the construction sector and other economic services supported economic activity in the first three months of 2023, the slowdown in activity in the manufacturing, trade and transport sectors had a negative impact.

As in the rest of the eurozone, Austria is witnessing a divergence between industry and services. Looking ahead, however, this divergence doesn't look sustainable. In fact, due to the loss of consumers' purchasing power and accelerating service inflation, the outlook for the services sector is also expected to become gloomier.

Sticky inflation to weigh on services sector

While other eurozone economies have recorded significant declines in headline inflation, the downward trend in Austrian inflation has been sluggish so far. In June, headline inflation in Austria came in at 7.8% year-on-year, against 5.5%YoY in the eurozone. Compared with the peak reached in October last year, headline inflation in the monetary union fell by 5.1 percentage points. In Austria, the decline in headline inflation between October 2022 and May this year was 3.8 percentage points only – the disinflationary trend beginning to unfold in other eurozone economies is being sought in vain in Austria.

This will affect the service sector in two ways. First, private consumption will suffer from persistently high price levels, especially since part of the cost of living is determined by administered prices, which in Austria are mostly indexed and thus increased based on inflation. This applies, amongst others, to public services, the rent of social housing or telecommunications. Moreover, services inflation is tending to accelerate, and there is no sign of an easing of price pressures in the sector.

Second, persistently high inflation will cause Austria's tourism sector to lose competitiveness. The hotels and restaurants component of the inflation basket recently became 13.1% more expensive year-on-year, and recreation and culture went up by 7%. In the eurozone, inflation in these categories was 8.4% and 5.7% respectively. If tourism in Austria becomes significantly more expensive than in other eurozone countries, tourists might switch to other holiday destinations.

Inflation in the services sector is also likely to be amplified by wage increases. Wages in the Austrian accommodation and food services sector increased by around 28% between the fourth quarter of 2019 and the first quarter of 2023. In the eurozone, wages in the sector came up by 16% over the same period. Strong wage growth in this sector was probably the result of a particularly high lack of skilled workers.

Austria's competitiveness will suffer

Increased costs are having a negative impact on competitiveness, not only in services but also in the manufacturing sector. Most Austrian exports are machines and vehicles, followed by processed goods and chemical products. While the competitive outlook for vehicles has improved recently, the results of DG ECFIN's industry survey in both the energy-intensive chemical products sector and the machinery sector point to a loss of competitiveness, both in relation to countries within and outside the EU.

Until the green transformation has comprehensively arrived in Austrian industry, no growth miracles are to be expected for Austrian industry or foreign trade. Consequently, the overall economic outlook is far from rosy. We expect economic growth in Austria to be significantly below potential both this year and next. Accordingly, the government debt ratio, which stood at 78.4% at the end of 2022, is likely to decline only slowly. After all, despite the frequent calls for a return to budget discipline, there has been no talk so far of either tax increases or significant spending cuts.

Overall, the outlook for the Austrian economy is clearly clouded and persistently high inflation will be an additional burden this year and next.

The Austrian economy in a nutshell (% YoY)

	2022F	2023F	2024F	2025F
GDP	4.9	0.5	0.6	1.5
Private consumption	4.4	0.5	2.0	1.5
Investment	0.3	0.3	1.2	2.0
Government consumption	2.9	-0.1	0.5	1.0
Net trade contribution	-0.1	-0.3	0.8	1.4
Headline CPI	8.6	7.0	2.4	2.0
Unemployment rate (%))	4.8	4.9	4.5	4.4
Budget balance as % of GDP	-3.2	-2.8	-1.3	-1.0
Government debt as % of GDP	78.4	77.0	75.0	72.0

Refinitiv Datastream, all forecasts ING estimates

After exceptionally strong growth for Portugal, a slowdown is looming

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The Portuguese economy, driven by strong export dynamics in the first quarter, is expected to face a significant slowdown due to a weakening global economic context and rising financing costs. Although a further decline in inflation is expected, the inflation slowdown is hampered by increased wage growth

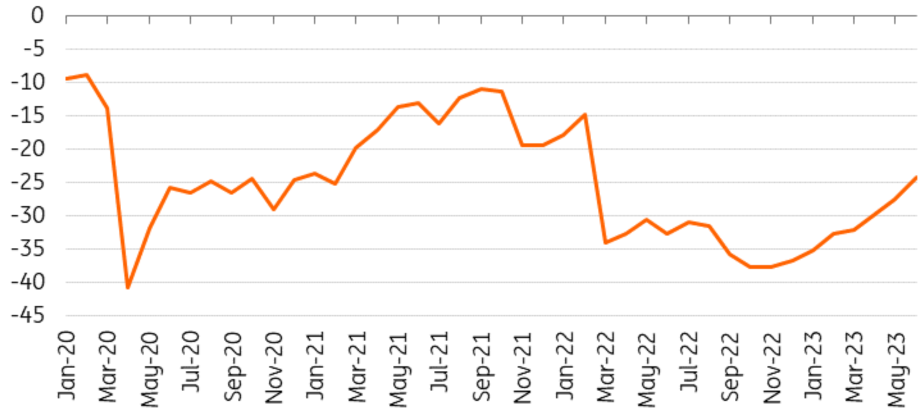
Portugal's tourism sector is thriving

Strong first-quarter growth will not be sustained

In the first quarter, the Portuguese economy experienced 1.6% quarter-on-quarter growth, primarily driven by robust export dynamics. However, this positive momentum will be increasingly challenged by the tightening of monetary policy. As households and companies become more cautious about taking on new loans, consumption and investment will slow down. The coordinated tightening of global monetary policy will also contribute to weaker global growth prospects, which will dampen Portuguese export dynamics –an essential driver of economic growth in the first quarter.

Despite numerous interest rate hikes, we maintain a positive growth scenario. For the second quarter, we still anticipate growth of 0.4% quarter-on-quarter, which is expected to decrease further to 0.2% in both the third and fourth quarters of this year. Positive factors such as favourable labour market developments, increased inflows of European funds, government measures to support income, and a thriving tourism sector partially mitigate the impact of higher interest rates. Additionally, consumer confidence has risen to its highest level since the start of the war in Ukraine, boosted by rising wages which have already risen more than 7% in certain sectors.

Cautious recovery in consumer confidence



Source: European Commission

Looking ahead to 2024, we expect full-year growth of 1.1%. With this forecast, we differentiate ourselves from other institutions that have a higher growth forecast for the Portuguese economy. Our projection takes into account a more pronounced influence of monetary policy on economic growth. This effect will already be felt in the second half of 2023, which also gives us a smaller spillover effect into 2024.

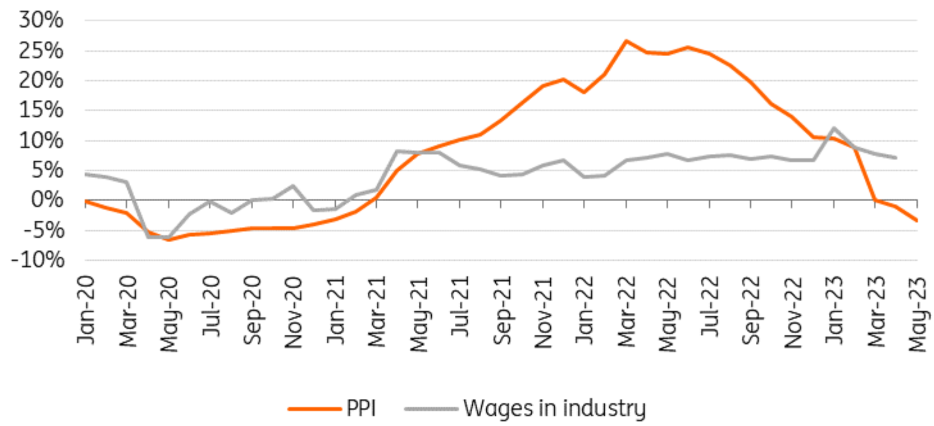
Moreover, the European Central Bank is expected to implement some additional interest rate hikes in July and September this year, the full impact of which will not be fully felt until 2024.

More signs that core inflation will fall further

Inflation has fallen significantly and is expected to remain on a downward path for the rest of the year. This decline can be attributed to the expected fall in energy and food prices, which gradually impact core inflation. Portugal's Producer Price Index (PPI), which measures the cost of inputs such as raw materials, intermediate goods and energy to businesses, is often considered an early indicator of inflationary pressures in the economy. The PPI in particular has fallen sharply: in May, producer prices fell 3.4% from a year earlier. These factors will contribute to further deflationary pressures on inflation.

However, wage growth will be the main driver of inflation, countering the downward pressure from lower energy and input costs. As companies pass on higher wages to consumers through higher prices, inflation will fall more slowly. For the rest of the year, the favourable base effect of energy will also gradually dissipate, which could push up overall inflation again. Our projections assume an average inflation rate of 5% for 2023 and 2.5% for 2024.

Falling producer prices, but wages rise



Source: INE

A significant growth slowdown in the pipeline

While we continue to expect continued economic growth for the rest of the year, we expect a significant slowdown after the strong start. Export dynamics, the major growth driver in the first months of the year, are likely to be affected by a deteriorating global economic environment and a significant rise in financing costs. While we expect a further decline in inflation, this downward trend will be tempered by upward pressure from rising wages.

The Portuguese economy in a nutshell (% YoY)

	2022	2023F	2024F	2025F
GDP	6.7	2.6	1.1	2.0
Private Consumption	5.8	1.0	1.1	1.5
Investment	3.0	2.6	3.4	4.4
Government consumption	1.7	1.4	1.0	0.8
Exports	16.7	7.0	2.9	3.7
Imports	11.1	4.2	3.9	3.5
Headline CPI	7.8	4.6	2.3	2.1
Unemployment rate (%)	6.0	6.9	6.8	6.6
Budget balance as a % of GDP	-0.4	-0.2	0	0.1
Government debt as a % of GDP	113.9	106.2	102.4	98.4

Source: ING research

Ireland's boom continues for now

The Irish economy appears to be going from strength to strength, growing rapidly following a solid start to 2023. Ireland isn't immune to global headwinds, however, and growth expectations could soon begin to slow as high inflation, rising interest rates and weaker global demand take their toll

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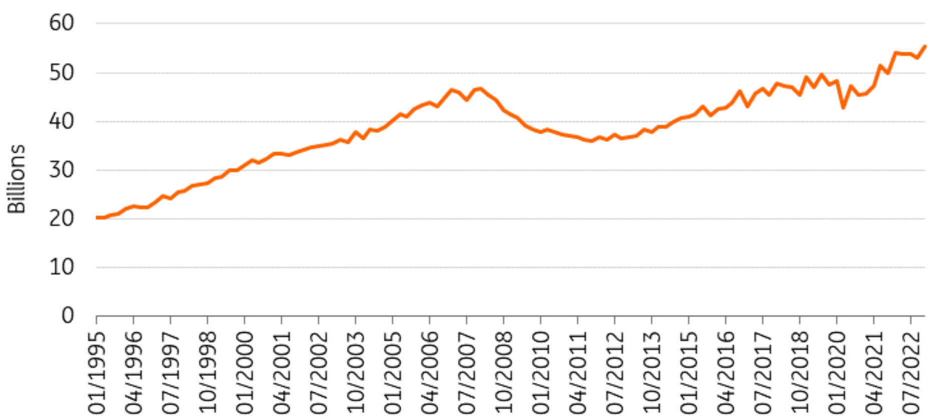
Global headwinds weigh on surging growth

It was a confusing start to the year for the Irish economy. We saw GDP shrink by -4.6% quarter-on-quarter – mainly driven by multinational dominated sectors – while the domestic economy actually bounced back from a few weaker quarters and grew by 2.7%. This signals continued strength in the overall trend for Ireland and suggests that the boom of recent years has not yet come to an end. This year, we continue to expect an outperformance of the Irish economy compared to its European peers – although Ireland is also not immune to broader drivers of weakness. As a result, high inflation, higher interest rates and weaker global demand are dampening the growth outlook for the year ahead.

Modified domestic demand saw a strong bounce back from weakness at the end of 2022



Source: CSO

Purchasing power and business expectations to provide support

The services sector continues to be a very strong driver of economic activity in Ireland for the moment. The PMI for services was at 57 in June, well above the eurozone average and indicative of strong expansion. The manufacturing PMI indicates contraction, although traditional industrial production continues to show strong year-on-year growth for the moment. The strong service sector reflects large business services activities, but also strong domestic consumption activity. Unemployment stands at a very low 3.8%. Wage growth trends above 4% at the moment, not too far from where inflation sits. Over the course of the year, purchasing power is set to improve again, which should provide further support for consumption activity.

The housing market, however, is starting to turn. Price growth has been negative for a few months, although the latest data suggest a bottoming out. Mortgage approvals have increased again in March and April, which adds to tentative signs of a bottom. Keep in mind the full impact of higher interest rates may still have to play out. Still, the market remains tight with structural undersupply, which dampens the negative effect of higher rates on Irish housing. Construction activity is set to rebound in the months ahead. While the PMI has been negative for some time, commencements have been on the rise again and business expectations have been improving. Expect this to support the economy over the rest of the year.

Strength in government finances accompanies economic boom

Overall, this strong economic performance – to a large degree fueled by multinational activity – is resulting in sound government finances. Windfall corporate taxes are an important contributor to that. Talk of a sovereign wealth fund also appears to be emerging, which is a luxury that many eurozone countries would only dream of. In the fourth quarter of 2022, Irish government debt stood at 44.7% of GDP, which is more than 10 percentage points down from the previous year. Clearly, the economic boom is now accompanied by a strong improvement in government finances.

Can Finland make its way out of recession for the remainder of 2023?

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Finland was in a technical recession in the second half of 2022 but recovered some of its losses at the start of 2023. We don't expect a double dip as our base case, but a vibrant bounce-back seems unrealistic given weak global demand, high inflation and elevated rates are weighing on the recovery

Finland has experienced a modest recovery in 2023 so far, following a technical recession in the second half of last year

The Finnish economy was among the first in the eurozone to enter into a technical recession last year. Quarterly declines of -0.2% and -0.5% in GDP in the third and fourth quarters of 2022, respectively, were not negligible and relatively broad-based as consumption, investment and net exports all contributed to the declines. The purchasing power squeeze, weakening global demand, a higher reliance on Russia, and higher interest rates were important drivers of last year's weakness.

So far, 2023 has been a year of modest recovery. GDP grew by 0.4% in the first quarter, which means that recovery is underway. Statistics Finland provides a trend indicator of output, which showed a sharp uptick in activity in April, indicating that the recovery was still ongoing at the start of the second quarter. Still, the pace of growth is set to lose steam due to factors like weakening global demand, fading post-pandemic spending on services, and higher interest rates, which leads us to believe that annual growth of just 0.1% is a realistic outcome for the year. So we do not expect a strong recovery from here on, but an economy that will struggle to gain momentum as headwinds mount in the second half of the year.

Upsides to the outlook should come from fading inflation and regained purchasing power. The historically strong labour market participation has boosted incomes, which will now also be supported by faster-rising wages. That should dampen the negative effects of inflation. With inflation trending down, real wage growth provides an upside to personal consumption over the second half of the year. The question is how the current spell of economic weakness is affecting the labour market. We don't expect a large uptick in unemployment given current labour shortages, but rising unemployment and easing labour market tightness could dampen the real wage recovery.

The weaker cyclical conditions put government budgets and debt ratios under pressure. The budget deficit is weakened, among other factors, by increased defence spending and a higher debt service on the back of more elevated interest rates for the coming years. This means that the debt-to-GDP ratio is unlikely to make progress towards the 60% target. In fact, expectations are that it will trend up from the current level of 73%.

The Finnish economy in a nutshell (% YoY)

	2022	2023F	2024F	2025F
GDP (%)	2.1	0.1	0.7	1.1
Private consumption (%)	2	0	0.7	0.9
Investment (%)	5	-3.5	1.3	3.4
Government consumption (%)	2.9	1.6	0.2	0.2
Net trade contribution (%)	-0.2	0.2	0.2	0.2
Headline CPI (%)	7.2	4.7	2.1	2.2

Source: ING research

Eurozone housing market is still searching for the bottom

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High interest rates, economic uncertainty, increasing renovation costs and questions over future energy efficiency requirements continue to add downward pressure on house prices. In our view, the bottoming out will only start towards the end of the year and the recovery of the eurozone housing market will take some time to materialise

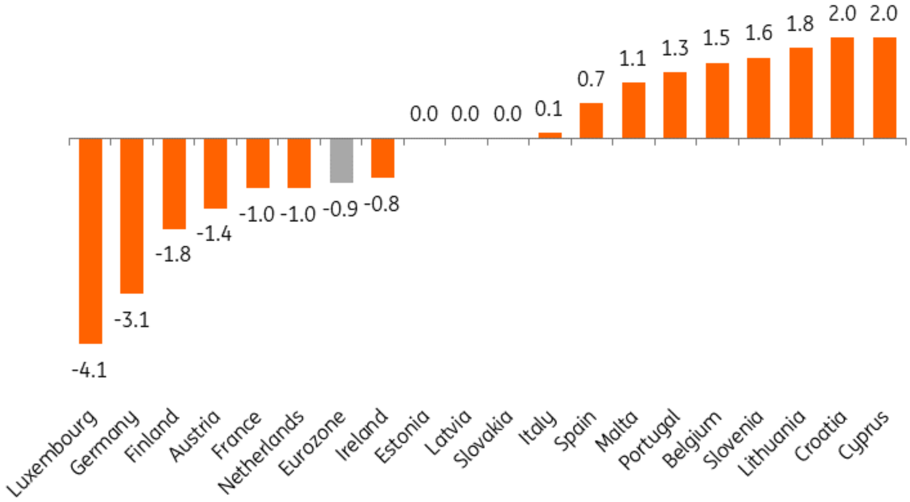
A modern housing block in Milan, Italy

Drop in demand hinders recovery

Mortgage rates have risen sharply over the past year, resulting in a slowdown in demand for housing loans. House prices in the region have also been pushed down as sellers have adjusted their asking prices. New production of housing loans in the eurozone in the first five months of this year was more than 60% below last year's volume, and the number of housing transactions has also seen a significant drop. In the first quarter of 2023, for instance, it fell 23% in Belgium and the Netherlands compared to the previous quarter, 16% in France, and 8% in Spain. With mortgage production leading housing transactions, a further decline in the number of transactions is still to be expected.

Eurostat figures published last Wednesday showed that the fall in demand led to a 0.9% quarter-on-quarter drop in property prices in the eurozone, after a 1.7% QoQ fall in the fourth quarter of 2022. Looking ahead, it appears unlikely that we'll see a robust recovery any time soon. We expect demand to pick up slightly only at the end of the year, with prices following suit in the first half of 2024. Besides the negative impact of the rise in financing costs on prices, the green transition in the housing market will play an increasingly important role in price setting.

House price growth 1Q23, % QoQ



Source: Eurostat

Higher for longer means bottoming out later

About a year ago, the European Central Bank (ECB) engaged in the most aggressive interest rate hike cycle since the start of the monetary union. Interest rates for housing loans have also shot up, financing costs have risen significantly and demand for housing loans dropped sharply. While the economic outlook has weakened lately and there are increasing signs that the monetary policy transmission is working, the fear of pausing too soon is currently greater within the ECB than the fear of doing so too late.

We expect the central bank to raise policy rates by 25 basis points at both its July and September meetings. As a consequence, capital market rates will move up slightly and will only start to stabilise or begin to come down at the end of the year. Demand for housing loans will therefore be dampened for longer and may also follow a similar pattern.

Rising interest rates drive affordability to historically low levels

The recent rise in interest rates has made a significant impact on the affordability of residential real estate, putting a heavier financial burden on prospective homeowners. The sharp rise in energy prices last year exacerbated the situation, leaving families with less money for mortgage payments after paying their energy bills. Consequently, many people chose to postpone their purchase plans, leading to a noticeable drop in demand for credit and downward pressure on house prices. Since interest rates will remain higher for longer, it seems likely that mortgage rates will increase somewhat further in the second half of the year, putting additional pressure on affordability.

Several factors partially mitigated the negative effects of rising interest rates on the housing market. These include a tight labour market, a pick-up in nominal wage growth after a sharp fall in real wages last year, an extension of average loan maturities and the implementation of government support measures. The sharp fall in energy prices also took some pressure off as households had to spend a smaller proportion of their income on their energy bills.

In some eurozone countries, house prices fell significantly from their peak levels. Those positive drivers, however, only offset part of the negative effect of interest rates this year. In our view, housing affordability is expected to remain low throughout 2024, mainly due to a 'higher for longer' interest rate environment.

Green transition as structural key driver

Looking further ahead, the role played by energy efficiency in the housing market is likely to grow. Both regulatory drivers and government investment, as well as changing consumer preferences are pulling in that direction. The surge of energy prices in 2022 and remaining uncertainty about future energy prices have made home buyers increasingly aware of the benefits of more energy efficient homes. European and national initiatives to reduce CO2 emissions from buildings will further disrupt the market. This seems to have recently increased the price premium for energy efficient homes compared to those which consume more energy.

Demand for energy efficiency is growing, but lacking labour capacity and higher material prices provide bottlenecks on the supply side of the market to meet the extra demand for energy efficient homes. Given the structural nature of labour shortages, this delays the renovation of the housing stock needed to meet the climate goals.

Overall, we expect house prices in the eurozone to fall by some 3.5% to 5% on average this year. House prices are likely to develop differently across eurozone countries, with Germany and the Netherlands seeing rather significant declines in house prices, while house prices in Belgium are only expected to fall slightly. However, there will be differences in price developments not only between countries but also between segments, with energy efficiency playing an increasingly decisive role in price-setting. The price of energy efficient new buildings is likely to be higher, whereas older residential properties with poor energy efficiency are likely to see even greater price discounts than the new market environment already shows.

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