EUROZONE
2022-2023 SCENARIO

ADVERSITY IS WINNING THE BATTLE WITH RESILIENCE

July 2022

Paola Monperrus-Veroni

WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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SUMMARY

THE NORMALISATION OF THE REAL ECONOMY WILL TAKE LONGER

The scenario of a drawn-out conflict means that we are forced to base our outlook for the Eurozone on several working hypotheses that carry a high level of uncertainty.

The solid fundamentals of the private sector in the Eurozone and the *post*-Omicron rebound will not be sufficient to fully offset the shocks linked to the war: a contained, localised supply shock for now, a powerful but mitigated demand shock, and a terms-of-trade shock not amplified by wage increases.

We are downgrading our Eurozone growth outlook for 2022 and 2023, and its pace will fall below potential as of mid-2022.

The GDP gap to pre-pandemic levels, which has already been closed in France, Italy and the Eurozone average, will be filled a little later in Germany, but will not be closed in Spain within our forecast horizon.

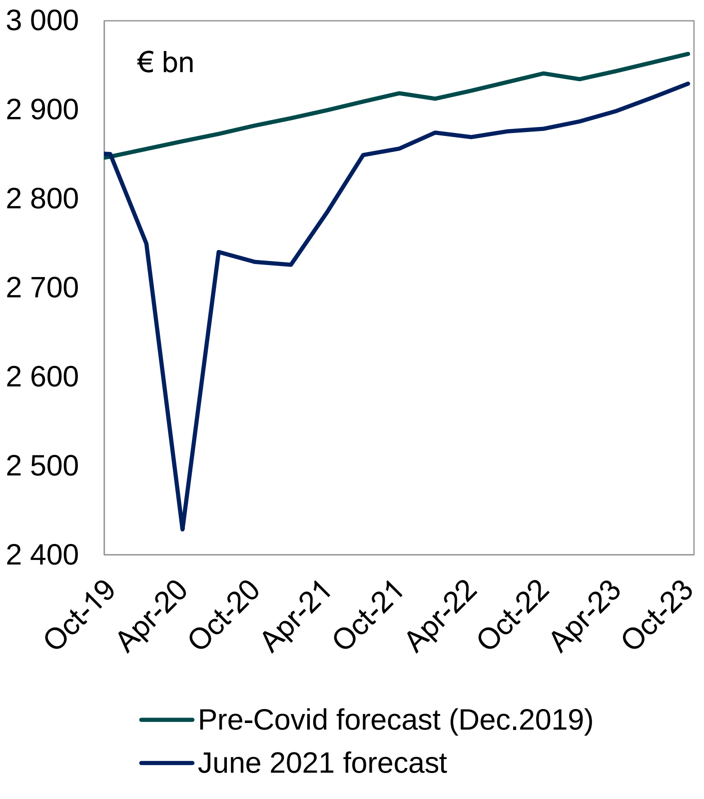
Average annual growth will remain high in 2022 at 2.5%, driven by a solid carryover effect (2.5%) and first-quarter growth of 0.6% (0.2% excluding the Ireland effect). **However, average quarterly growth is barely above zero. Amid moderating inflation, growth will rebound modestly in the second half of 2023, reaching an annual average of 1.1%.**

The likelihood of a risky scenario related to the cut-off of Russian gas supply is increasing. The later this occurs in our scenario, the more time substitutions and adjustments will have to take effect and mitigate the impact on growth. **In such a scenario, growth will be an estimated two points lower than in our central scenario due to three increasingly acute shocks**: a greater supply shock due to rationing, a demand shock that will bite harder given higher inflation and a larger confidence shock accompanied by revised asset valuations. Economic policy action will therefore be crucial to temper the impact on activity but will be restricted by increasingly complex trade-offs.

SUMMARY

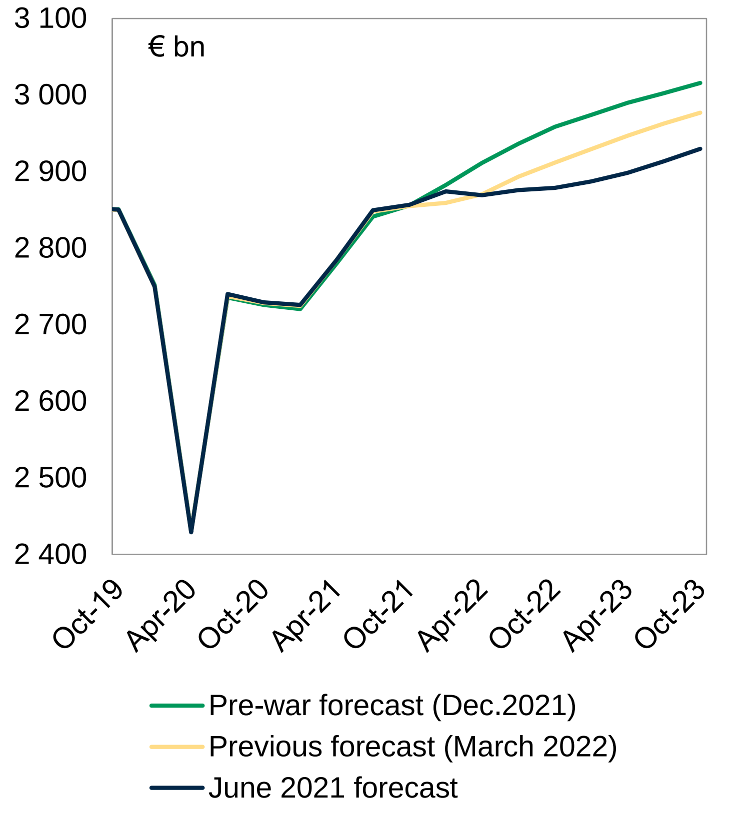
THE NORMALISATION OF THE REAL ECONOMY WILL TAKE LONGER

The pre-Covid trajectory is still far off



Sources: Eurostat, Crédit Agricole S.A.

The benefits of the recovery plans undermined by the war



Sources: Eurostat, Crédit Agricole S.A.

SUMMARY

EXCLUDING THE OVERHANG EFFECT, GROWTH IS ALMOST NIL AND BELOW POTENTIAL

Growth forecasts

	Quarterly rate (QoQ, %)												Annual rate (YoY, %)			
EMU	**2021**				**2022**				**2023**				**2020**	**2021**	**2022**	**2023**
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**				
GDP	**-0,1**	**2,2**	**2,3**	**0,2**	**0,6**	**-0,2**	**0,2**	**0,1**	**0,3**	**0,4**	**0,5**	**0,5**	**-6,5**	**5,3**	**2,5**	**1,1**
Households consumption	-2,2	3,8	4,5	-0,3	-0,7	0,1	0,1	0,0	0,2	0,4	0,5	0,6	-7,9	3,6	2,4	1,1
Public consumption	-0,1	1,9	0,4	0,4	-0,3	0,2	0,2	0,2	0,2	0,2	0,2	0,1	0,9	3,9	0,9	0,7
Total GFCF	0,1	1,4	-0,9	3,1	0,1	1,3	0,5	0,2	0,6	0,6	0,7	0,7	-7,2	4,1	3,6	2,3
G&S exports	0,9	3,2	1,9	2,7	0,4	0,7	1,0	0,7	0,6	0,6	0,7	0,7	-9,5	10,8	5,4	2,8
G&S imports	1,0	3,3	1,4	4,7	-0,6	2,3	1,0	0,8	0,6	0,6	0,7	0,7	-9,4	8,7	7,0	3,3
Inventory changes (% of GDP)	1,0	0,4	0,1	0,6	1,1	1,3	1,3	1,3	1,3	1,3	1,3	1,3	0,2	0,5	1,2	1,3
Contributions to GDP growth																
Domestic demand excluding inve	-1,2	2,7	2,2	0,6	-0,4	0,4	0,2	0,1	0,3	0,4	0,5	0,5	-5,6	3,7	2,2	1,2
Inventories	1,1	-0,6	-0,2	0,4	0,6	0,1	0,0	0,0	0,0	0,0	0,0	0,0	-0,5	0,4	0,8	0,0
Net exports	0,0	0,1	0,3	-0,8	0,5	-0,7	0,0	0,0	0,0	0,0	0,1	0,1	-0,4	1,3	-0,5	-0,1
Unemployment	8,2	8,1	7,5	7,1	6,9	7,1	7,2	7,4	7,3	7,2	7,2	7,2	8,0	7,7	7,1	7,2
Consumer prices	1,1	1,8	2,8	4,6	6,2	7,9	8,7	8,6	6,7	5,2	4,7	3,4	0,3	2,6	8,0	5,4
Unemployment	8,2	8,1	7,5	7,1	6,9	7,1	7,2	7,4	7,3	7,2	7,2	7,2	8,0	7,7	7,1	7,2

	Quarterly rate (QoQ, %)												Annual rate (YoY, %)			
Eurozone	**2021**				**2022**				**2023**				**2020**	**2021**	**2022**	**2023**
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**				
Eurozone	**-0,1**	**2,2**	**2,3**	**0,2**	**0,6**	**-0,2**	**0,2**	**0,1**	**0,3**	**0,4**	**0,5**	**0,5**	**-6,5**	**5,3**	**2,5**	**1,1**
Germany	-1,7	2,2	1,7	-0,3	0,2	0,2	0,3	0,1	0,1	0,3	0,5	0,6	-4,9	2,9	1,7	1,0
France	0,2	1,0	3,2	0,4	-0,2	0,3	0,2	0,3	0,3	0,3	0,4	0,4	-7,9	6,8	2,4	1,3
Italy	0,2	2,7	2,6	0,7	0,1	-0,1	0,1	-0,2	0,2	0,4	0,5	0,6	-9,1	6,6	2,5	0,8
Spain	-0,5	1,1	2,6	2,2	0,2	0,2	0,3	0,1	0,3	0,5	0,9	0,8	-10,8	5,1	3,8	1,6
Netherlands	0,1	3,8	1,5	0,7	0,4	-0,2	0,2	0,2	0,3	0,3	0,3	0,3	-3,9	4,9	2,6	0,9
Belgium	1,3	1,7	2,1	0,4	0,5	-0,3	0,1	0,1	0,3	0,3	0,3	0,4	-5,7	6,2	2,2	0,9
Ireland	9,5	5,0	1,9	-6,2	10,8	-6,0	0,5	-0,2	1,1	1,5	1,1	1,1	5,9	13,4	3,3	1,5
Portugal	-2,9	4,4	2,7	1,7	2,6	-0,8	0,3	0,4	0,6	1,1	1,1	0,5	-8,4	4,9	6,0	2,4
Greece	3,4	1,3	2,3	0,8	2,3	-1,9	0,3	1,1	0,6	0,5	0,5	0,7	-8,7	8,0	3,5	1,9
Finland	0,0	1,7	1,0	0,7	0,2	0,1	0,1	-0,1	0,3	0,3	0,4	0,4	-2,3	3,5	1,8	0,8
Luxembourg	2,1	0,8	0,9	1,0	1,2	0,6	1,2	0,7	0,8	0,6	0,6	0,6	-1,8	6,9	3,9	3,0
Austria	-0,5	4,3	3,4	-0,8	1,5	-0,8	0,1	0,0	0,2	0,3	0,3	0,3	-6,8	4,9	3,1	0,5

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A CONTAINED, LOCALISED SUPPLY SHOCK - FOR NOW

Reduced natural gas deliveries and the embargo on Russian oil and coal are a localised negative supply shock. There are substitutes, but but these solutions are limited in the short term, especially when it comes to natural gas. According to the International Energy Agency (IEA), only 10% to 15% of Russian natural gas imports could be replaced by LNG imports in the short term.

A quarter of the gas input used in electricity generation can be fairly easily replaced by other energy sources, depending on the country and their energy mix.

Although **households, industry and services can find substitutes for their energy consumption thanks to other inputs and final products that are less gas- and energy-intensive, natural gas cannot be replaced in many industrial processes** (chemical processes for example). **Substitution elasticity estimates for natural gas** in the Eurozone economies suggest that 10% to 20% can be substituted in the short term. However, this may increase in the longer term. Although **this elasticity is not high, the simple fact that it is not zero radically reduces the negative impact of the supply shock.**

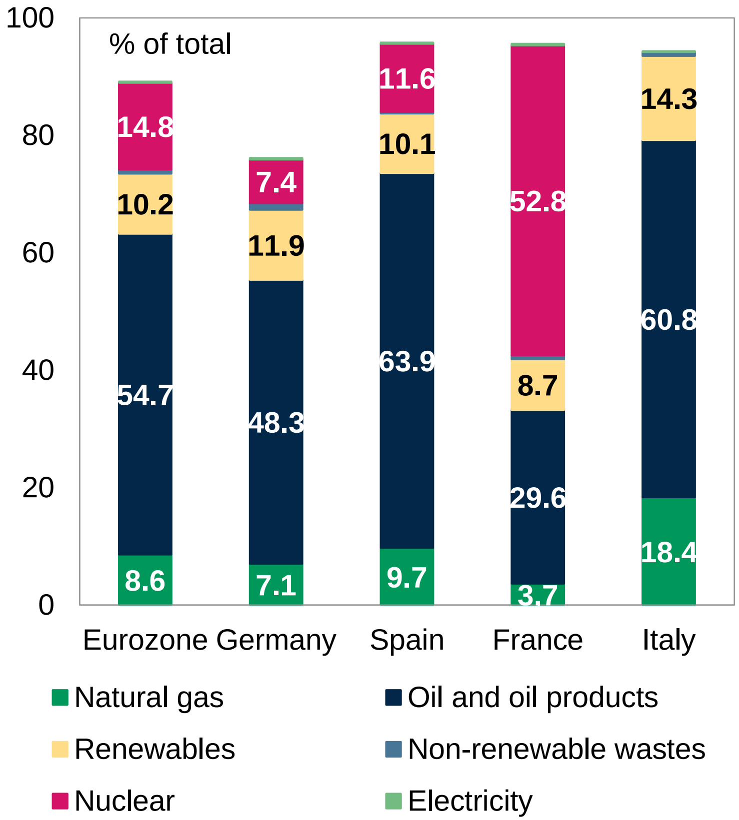
The role of gas as a critical input in certain production processes may generate value chain amplification. The hardest hit sectors are expected to be chemicals, agrifood, transport equipment, textiles, non-metallic minerals and construction. Germany and Italy are the most vulnerable of the region's major economies. As we go to press, both countries have only moved to stage two of their emergency plans, which balance supply and domestic demand using market-based measures encouraging voluntary reductions in demand by industrial users.

At this stage, no rationing is to be imposed. However, this could prove necessary if our forecast for a further drop in supply in mid-2023 is confirmed. We also take into account constrained production in certain sectors in our forecast.

A CONTAINED, LOCALISED SUPPLY SHOCK - FOR NOW

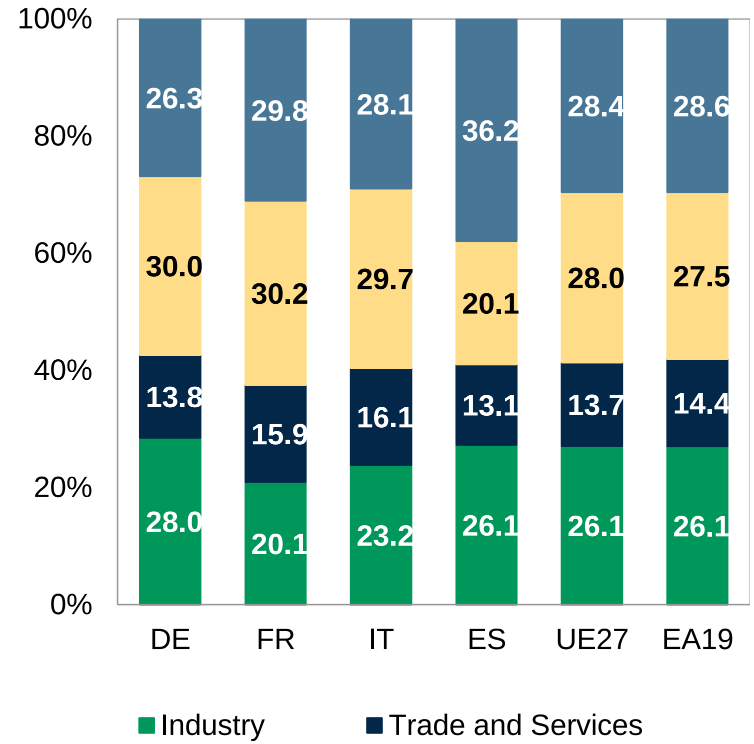
GAS: OPTIONS FOR SUBSTITUTION

Entry into energy transformation



Sources: Eurostat, Crédit Agricole S.A

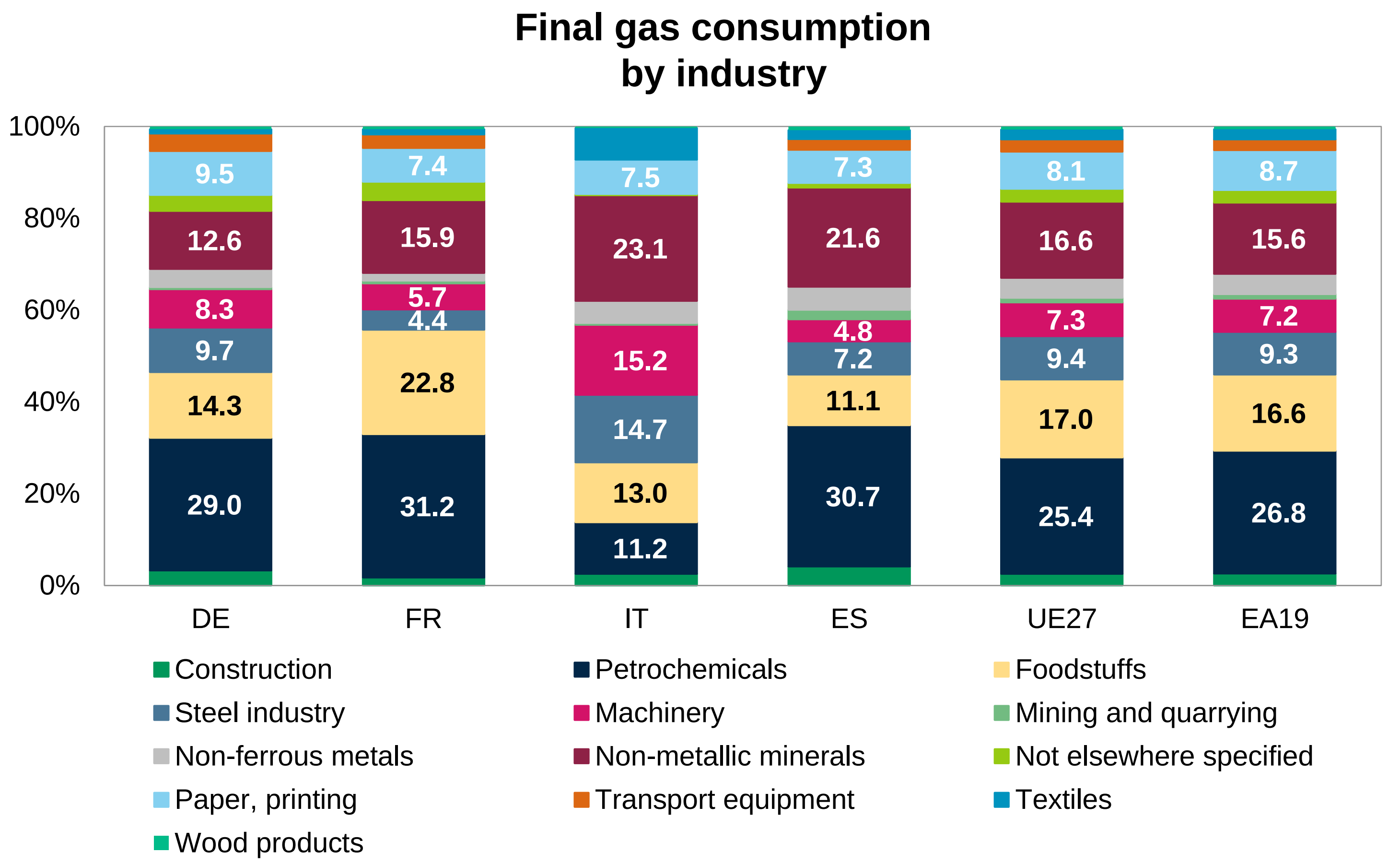
Final energy consumption by sector



Sources: Eurostat, Crédit Agricole S.A

A CONTAINED, LOCALISED SUPPLY SHOCK - FOR NOW

GAS: THE UNEVEN SUBSTITUTION BETWEEN SECTORS



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A POWERFUL BUT MITIGATED DEMAND SHOCK

Ultimately, the drop in Russian energy supply is primarily being transmitted in the form of a demand shock *via* increased prices and reduced purchasing power.

We are forecasting that inflation will peak in the second half of 2022 and, although it will decline on the back of base effects that will positively impact the price index's energy component, it will remain high in 2023.

Lost income is above 4.3% in 2022 and equal to 7% of households' irreducible expenses.

The increase in household disposable income was still at a rate (2.9% over the quarter) higher than that of inflation (2.2% quarter-on-quarter) in the first quarter of 2022, avoiding an erosion of purchasing power for the beginning of the year. This increase was based on an acceleration in the payroll (1.5%), resulting from both stronger growth in employment (0.6%) and wages per worker (1%). Hours worked also increased (+1.3% q/q), after the pause at the end of last year. Consumption growth was slower (1.9% in value terms) and even negative (in volume terms), thus increasing the savings rate to 15%.

This new rise in the savings rate increases the excess savings accumulated by households since the Covid crisis to €941 billion in the Eurozone.

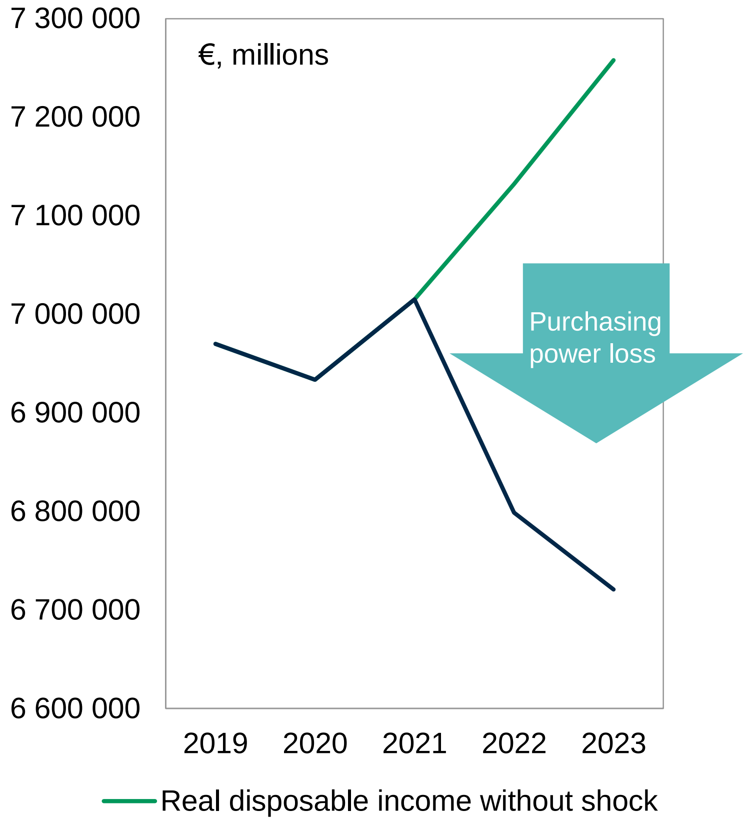
It is a powerful shock absorber for income losses due to rising inflation. It accounts for 12% of their income and therefore covers 2.8 times this loss of purchasing power.

Public support measures (decrease in taxes and excise duties on energy, capping of energy prices and support for household income) **amounted to 1.8% of disposable income and offset almost half of the loss of purchasing power.** Although excess savings are clearly skewed towards the wealthiest households, government support measures are primarily targeting the most vulnerable. **These mitigating factors do not entirely offset the loss of purchasing power, which is reason behind the sharp slowdown in household consumption in our forecast.**

A POWERFUL BUT MITIGATED DEMAND SHOCK

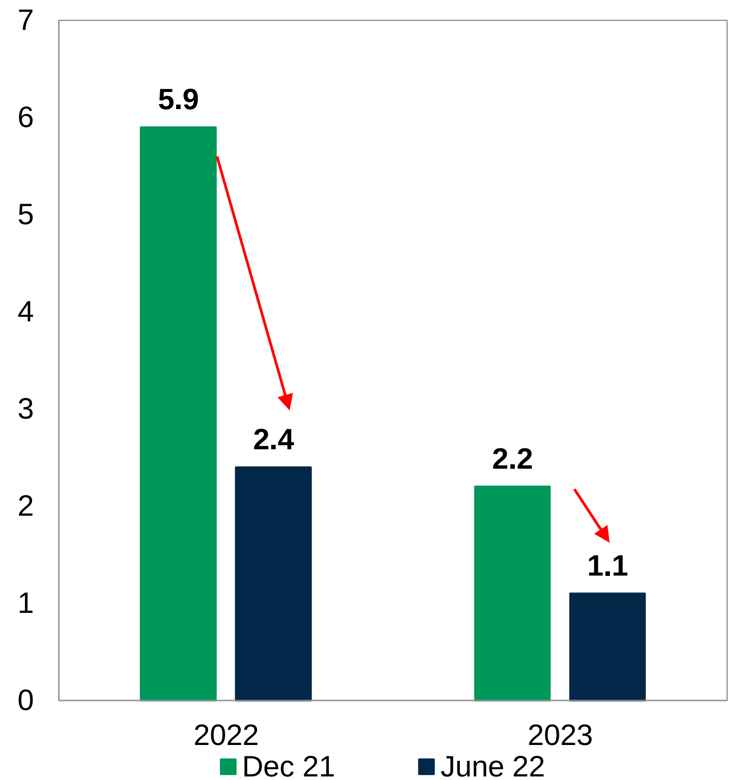
DECREASE IN PURCHASING POWER AND CONSUMPTION

Real disposable income: substantial losses



Sources: Eurostat, Crédit Agricole S.A

Sharp downgrading of consumption forecasts

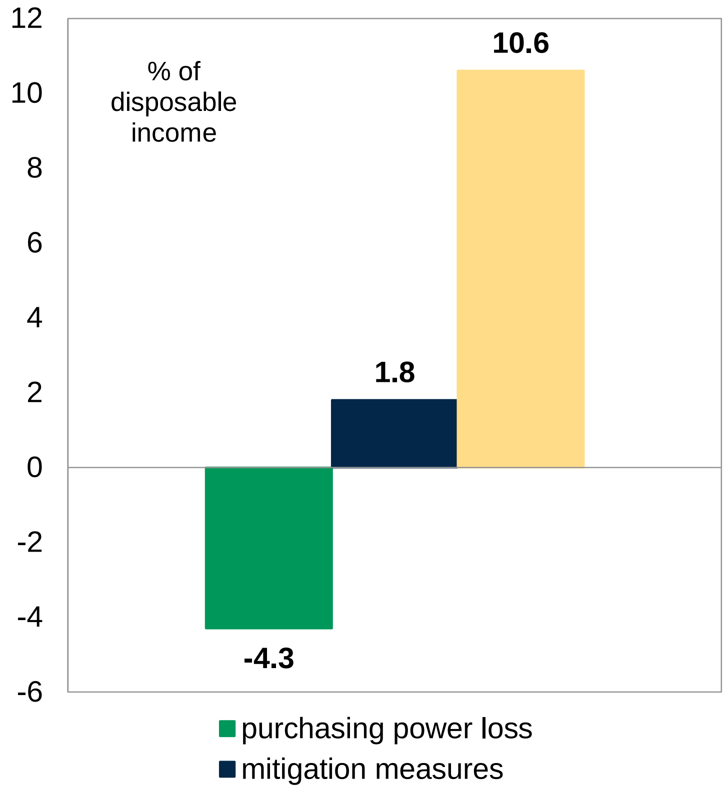


Sources: Eurostat, Crédit Agricole S.A

A POWERFUL BUT MITIGATED DEMAND SHOCK

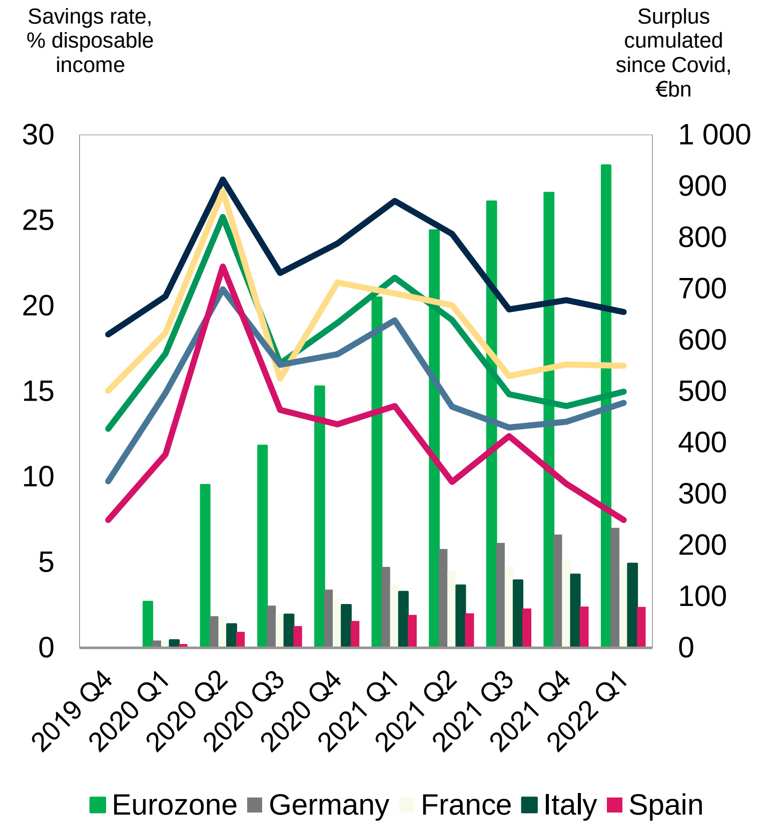
MITIGATING FACTORS

Excess savings and support measures mitigate the negative impact



Sources: Eurostat, Crédit Agricole S.A

Normalised savings rate but substantial savings surplus



Sources: Eurostat, Crédit Agricole S.A

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THE TERMS-OF-TRADE SHOCK NOT AMPLIFIED

The rise in inflation is a shock to terms of trade. It is mainly determined by the increase in the prices of imported goods (energy, commodities, intermediate goods). The increase in imports relative to exports reduces the Eurozone's current account balance. While in theory it can confer a competitive advantage, in practice rising costs and above all wages can lead to a transfer to selling prices, eradicating competitiveness gains. Our private consumption forecast assumes that **the wage response to higher inflation will be moderate, limiting the shock to trade terms by adding only a modest rise in unit wage costs and a moderate deterioration in competitiveness.**

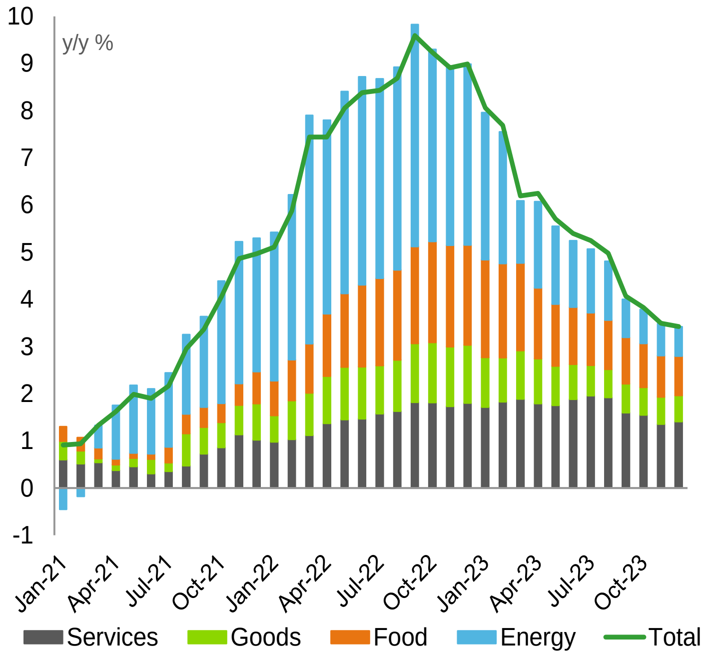
The repercussions of higher, more widespread and more persistent inflation **will be curbed by attempts to maintain employment in the face of a deteriorating economy.** Until clearer visibility on the inflation outlook is gained, purchasing power losses are expected to be offset by bonuses rather than wage increases. This is exactly the stance that was taken during the most recent round of collective bargaining. **A substantial carryover effect (3% in the first quarter of 2022) tied to higher numbers of hours worked, the impact of minimum wage increases in several countries and bonuses warrants solid growth per capita wage in 2022 (4.4%). However, in 2023, the trend will be more directly linked on the terms of collective bargaining agreements and, as such, is forecast at 3.3%.**

Given the normalisation of labour market participation, the unemployment rate will be mainly influenced by labour demand, which will be weakened by the slowdown in activity. **The renewed link between activity and the unemployment rate means that the latter is likely to rise slightly,** however, this will be mitigated by the resumption of short-time work schemes in certain manufacturing sectors hobbled by the supply shock.

THE TERMS-OF-TRADE SHOCK NOT AMPLIFIED

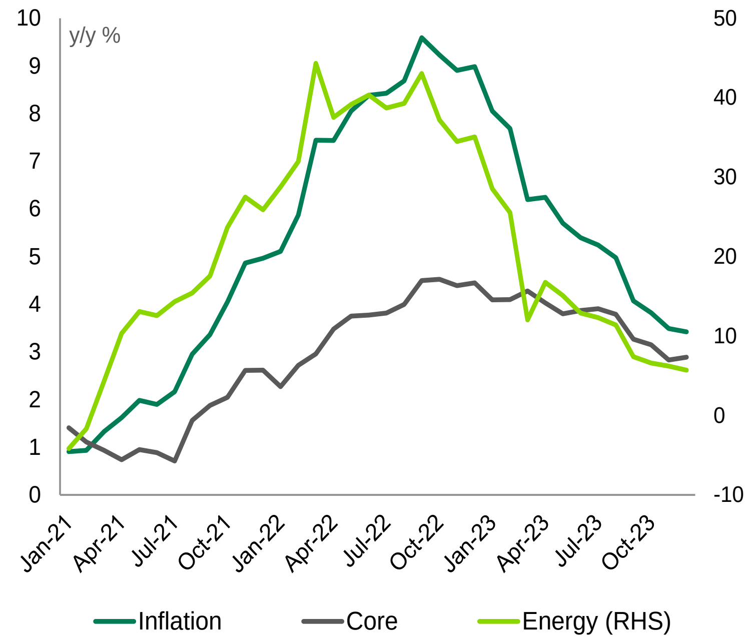
SIGNIFICANTLY HIGHER BUT ALSO MORE SUSTAINED INFLATION

Inflation: peak (uncertain) still to come



Sources: Eurostat, Crédit Agricole S.A.

Inflation: a biting inflation shock

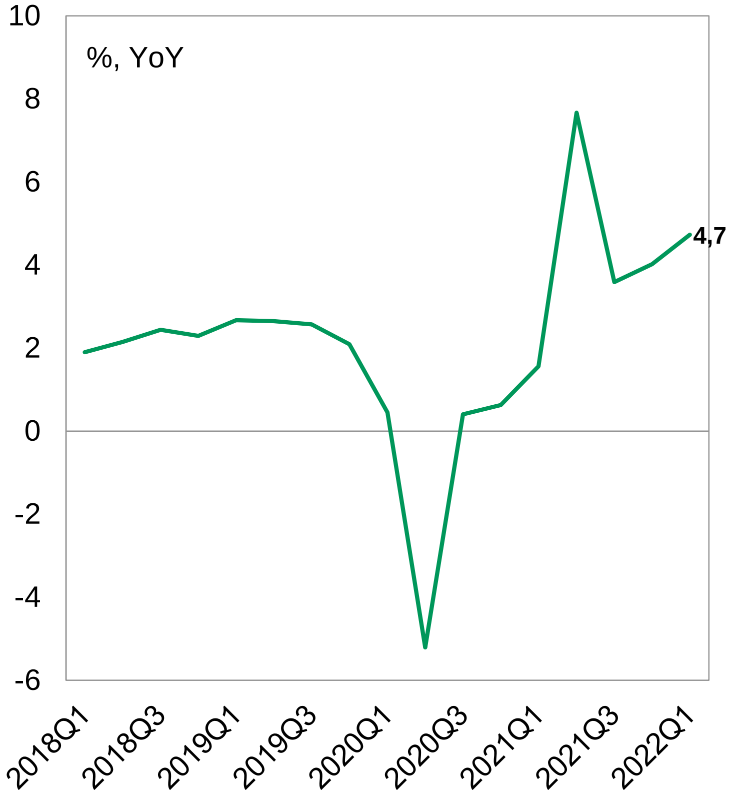


Sources: Eurostat, Crédit Agricole S.A.

THE TERMS-OF-TRADE SHOCK NOT AMPLIFIED

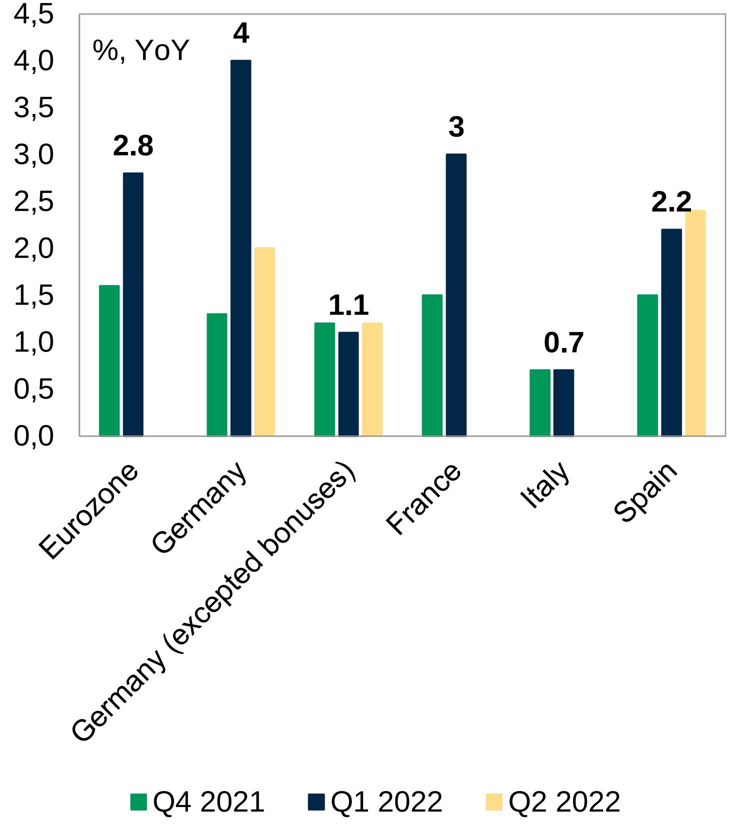
WAGES: MODERATE INCREASES

Wage per capita: substantial achievement, more modest trend



Sources: Eurostat, Crédit Agricole S.A

Negotiated wages

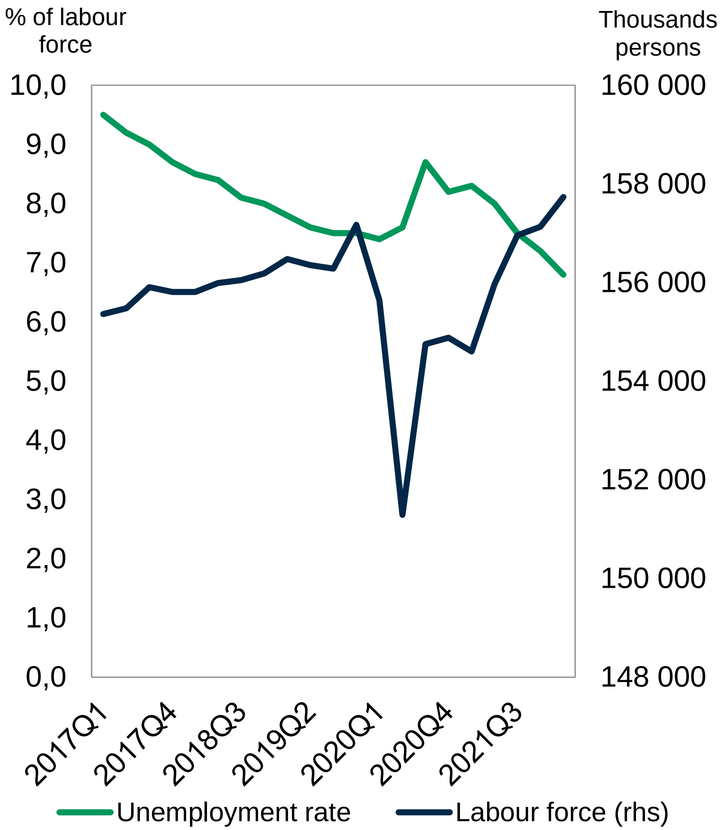


Sources: Eurostat, Crédit Agricole S.A

A NORMALISED LABOUR MARKET

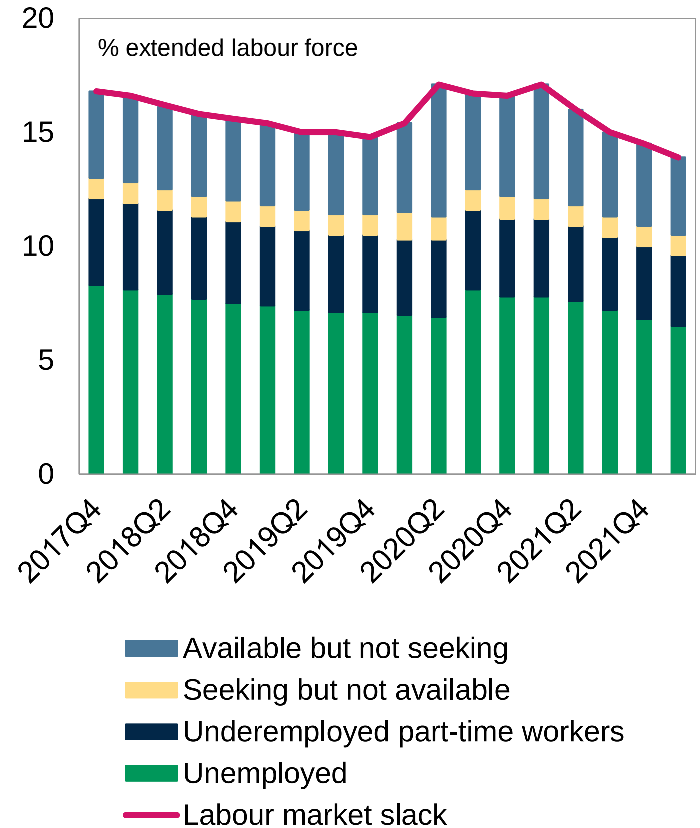
THE UNEMPLOYMENT RATE LESS DEPENDENT ON PARTICIPATION, MORE ON LABOUR DEMAND

Working population and unemployment



Sources: Eurostat, Crédit Agricole S.A

Sharp drop in excess capacity



Sources: Eurostat, Crédit Agricole S.A

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THE POLICY - MIX

In this typical scenario of a supply shock triggered by a market failure (due to the power of a monopolistic supplier), state intervention in prices is justified and looks to be superior to any other solution. **In the absence of more direct, joint action on natural gas prices, governments are adopting a targeted fiscal policy, reducing taxes and excise duties on energy and supporting the purchasing power of the hardest hit households and sectors. This policy will have an average budgetary cost of less than 1% of GDP and will be more than offset by the phasing out of COVID support policies and the improvement in the cyclical component of the public deficit.**

The fiscal stimulus excluding European funds will turn neutral once again, but the fiscal stance will maintain an accommodating bias thanks to the spending financed by the NGEU. The narrower deficit and negative interest rate-growth differential will further reduce the debt-to-GDP ratio in 2022. However, in 2023, the deficit reduction will not be enough to maintain the downward trend.

The rise in inflation is very complex to manage for the European Central Bank, because it stems from a pure supply shock against which monetary action has limited effectiveness. Monetary policy cannot curb the inflation of commodities and imported intermediate goods. It can act to limit the triggering of a price-wage loop that would make inflation more sustainable, moderating activity and labour demand.

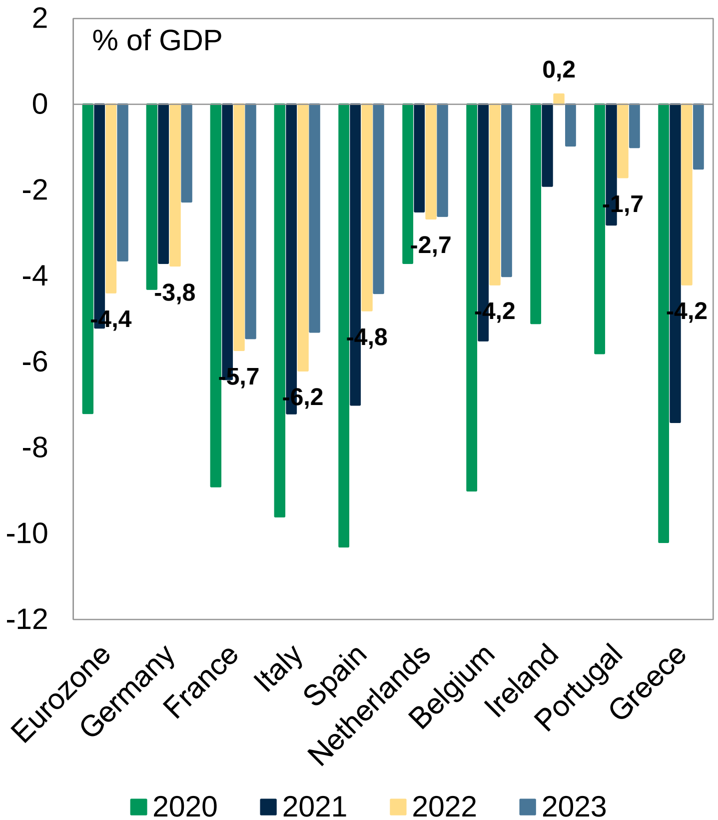
The start of a wage inflation spiral is not yet visible in the Eurozone, but could be fuelled by a drop in inflation expectations. However, the central bank can act to maintain inflation expectations anchored to its target. And the ECB will do everything for this, or at least will have us believe that it will do everything.

This is how we must interpret the more aggressive tone of the last two statements by the Governing Council. Any excessive response, leading to a disproportionate tightening and dispersion of financial conditions, will have to deal with the risk of fragmentation against which the ECB has also committed to act.

FISCAL POLICY

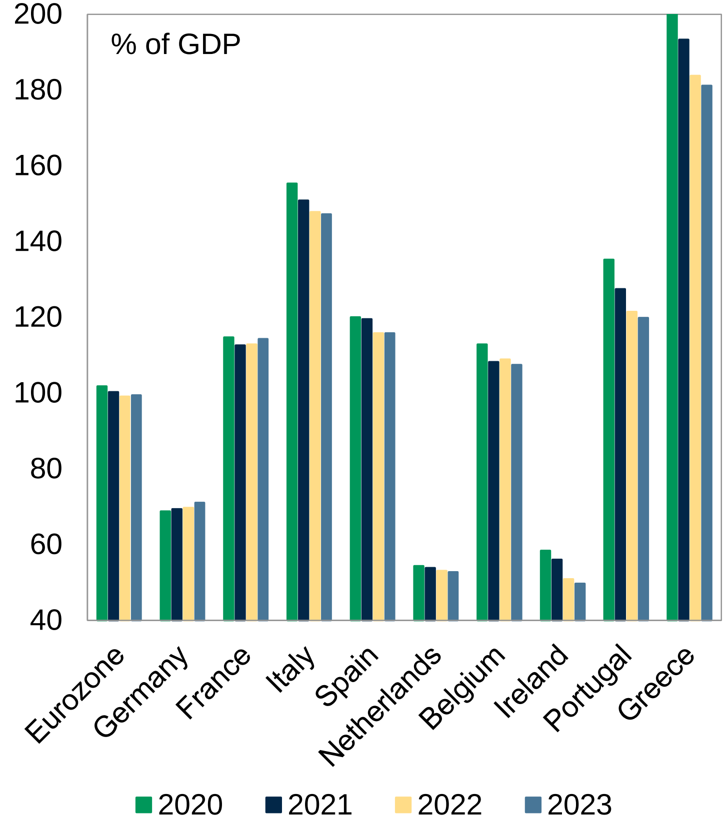
NORMALISATION ALSO DELAYED

Public balance: still improving



Sources: AMECO, Crédit Agricole S.A

Public debt: interrupted fall

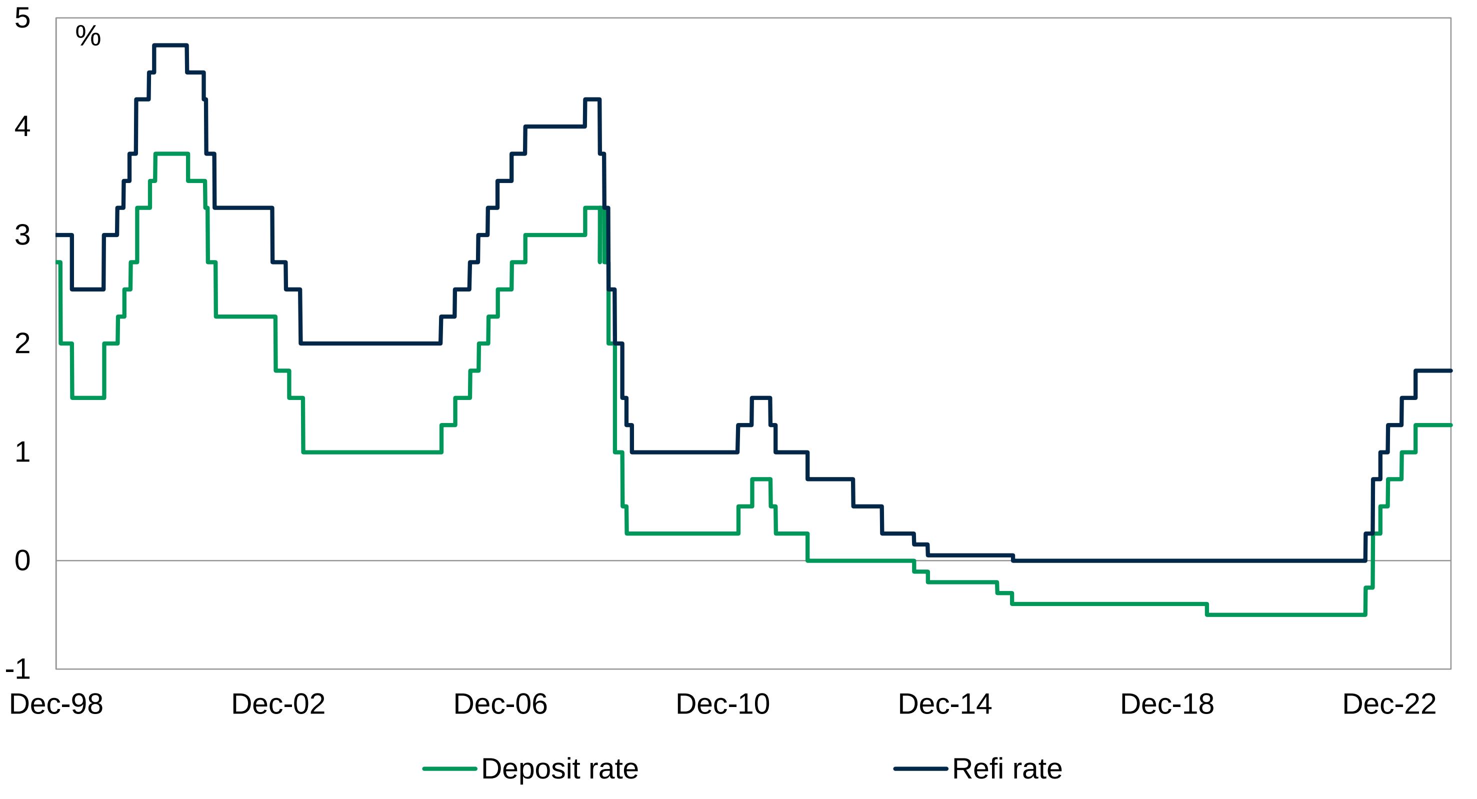


Sources: AMECO, Crédit Agricole S.A

MONETARY POLICY

TARGETING EXPECTATIONS

ECB: a new monetary tightening cycle



Sources: ECB, Crédit Agricole CIB

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