EUROZONE
2023-2024 SCENARIO

AN UNUSUAL MIX OF POWERFUL SUPPORTIVE AND DETRIMENTAL FACTORS

April 2023

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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SUMMARY

RESILIENCE HINGES ON THE IMPACT OF TWO POWERFUL AND CONTRASTING FORCES

Eurozone economic activity has dipped substantially on adverse shocks and high uncertainty. But the surprising resilience of the economy has prevented a recession.

The tension between a healthy private sector and persistently higher core inflation is making it harder for the ECB to manage the transition, the key challenge being to shift as smoothly as possible from this resilience to the end of the expansion phase.

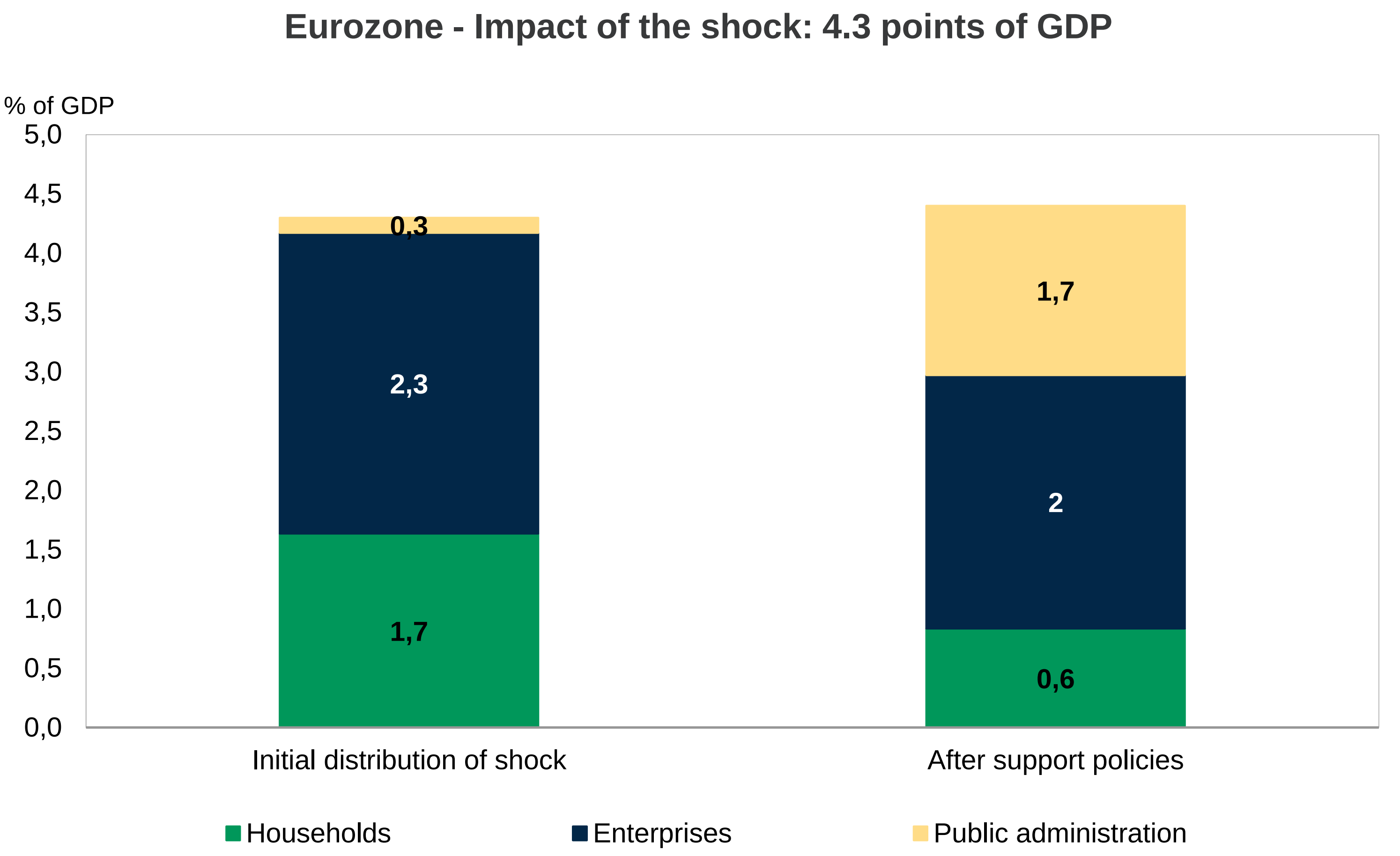
Our scenario is for a soft landing, with GDP growth of 0.6% in 2023 and 1.2% in 2024 – slightly less optimistic than the consensus. This outcome **is underpinned by the ebb in inflationary pressures and the initial impacts of monetary tightening, particularly on investment.** But the timing and effects of pro-cyclical monetary tightening could still come hand in hand with downside risks over the period in question if rising interest rates hit the labour market and credit cycle harder than expected. This trade-off is not unique to the eurozone and could be complicated if high inflation were to linger, leading to a sharper global economic downturn with negative consequences for global demand for the eurozone and financial stability. A contraction in eurozone growth has been relegated to a risk scenario.

Although GDP growth in the fourth quarter of 2022 was only marginally negative (-0.03%), the result conceals a deterioration in domestic demand that will continue in Q1 2023.

As such, our scenario is characterised by positive, albeit modest, GDP growth, which will pick up slightly beginning in mid-2024. The decrease in competitiveness resulting from the increased cost of imported energy (estimated at 4.3 points of GDP) was offset in part by fiscal measures aimed at limiting the cost of rising energy prices for households and businesses. With inflation dipping as expected, these measures will be reduced in several eurozone countries in first-half 2023. **Despite a more moderate increase in prices, the cost of energy in the eurozone will remain higher than before. This will result in lower long-term growth, continued redistribution between sectors and economic agents, and structural changes in energy consumption behaviour, which are already visible** (with gas consumption having dipped by around 15% in 2022).

AN UNUSUAL MIX OF POWERFUL SUPPORTIVE AND DETRIMENTAL FACTORS

RESILIENCE BOOSTED BY THE CUSHIONING OF UNFAVOURABLE SHOCKS

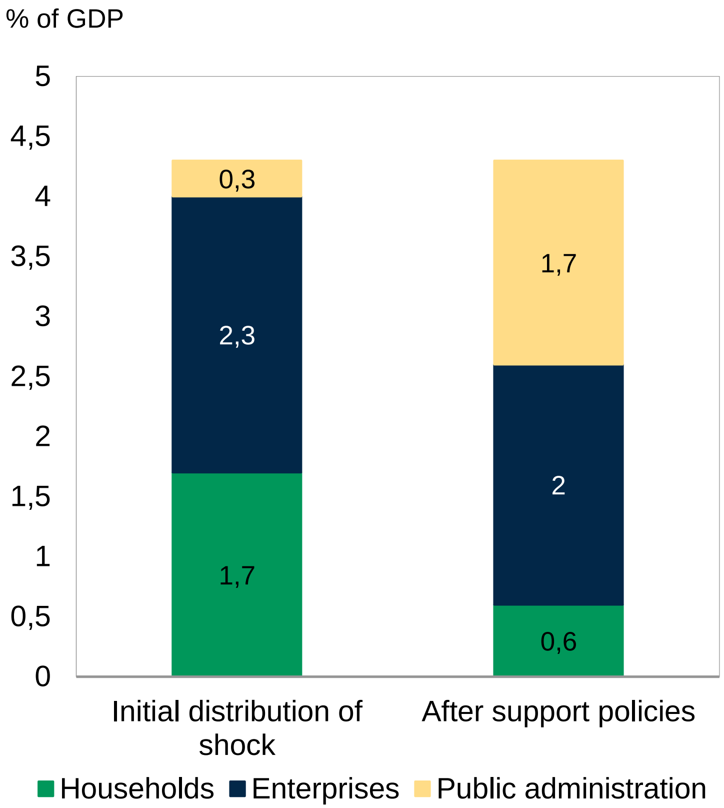


Sources: Crédit Agricole S.A./ECO

IMPACT OF ADVERSE SHOCKS

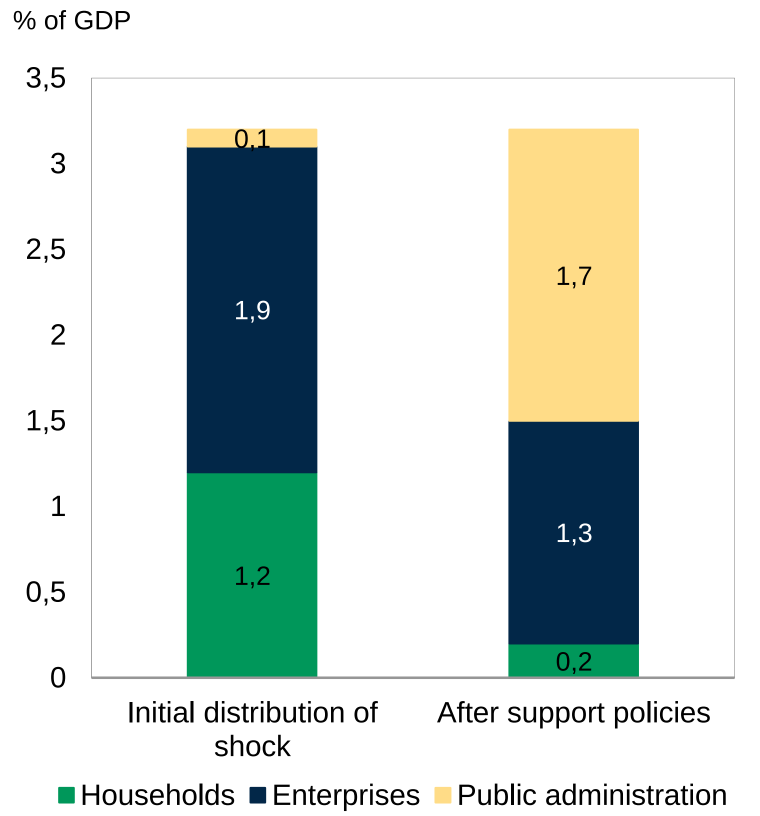
MITIGATION VIA FISCAL POLICY

Germany - Impact of the shock: 4.3 points of GDP



Sources: Crédit Agricole S.A./ECO

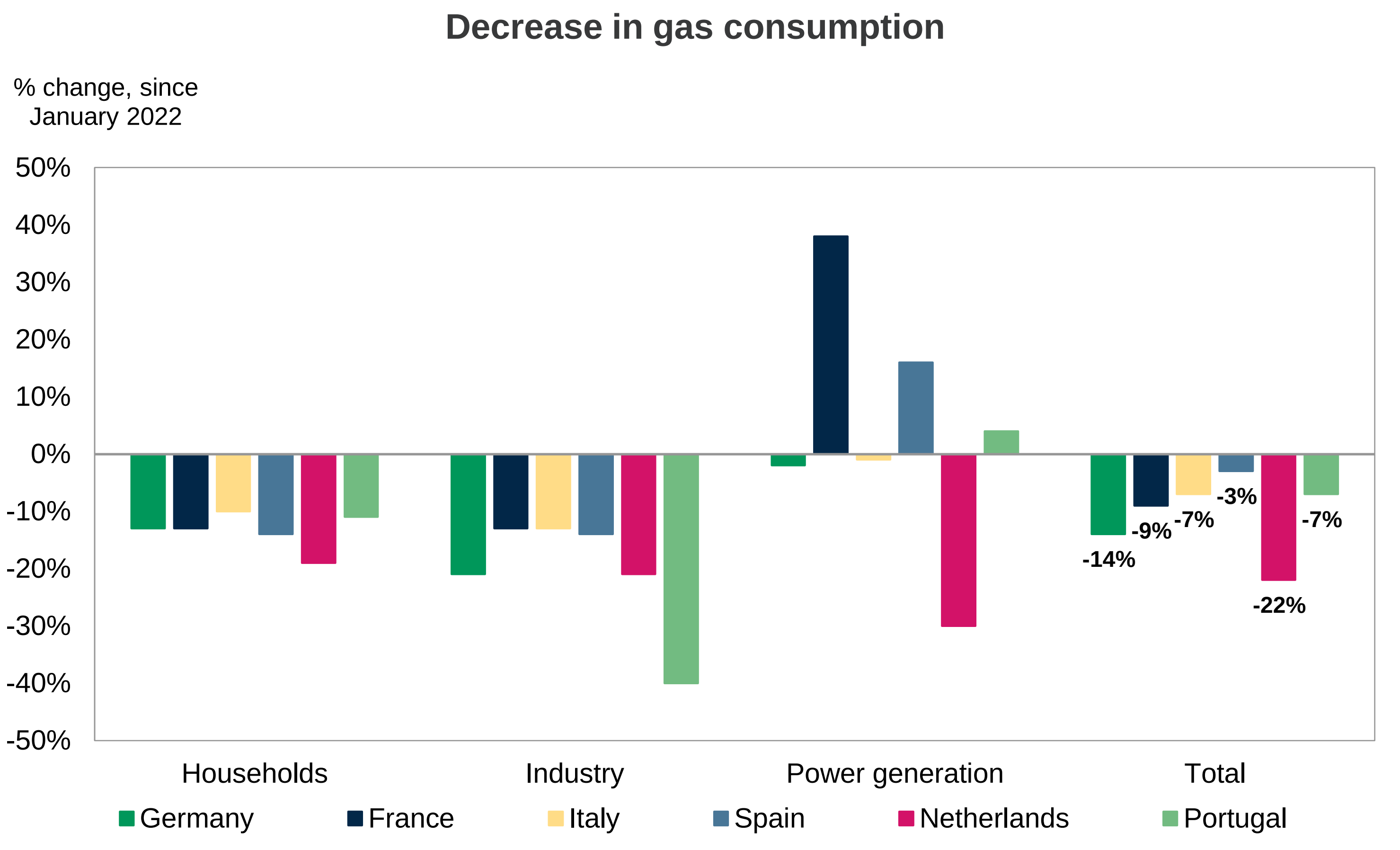
France - Impact of the shock: 3.2 points of GDP



Sources: Crédit Agricole S.A./ECO

STRUCTURAL ADAPTATION EFFORTS

BEHAVIOUR AFFECTED BY PRICE SIGNAL

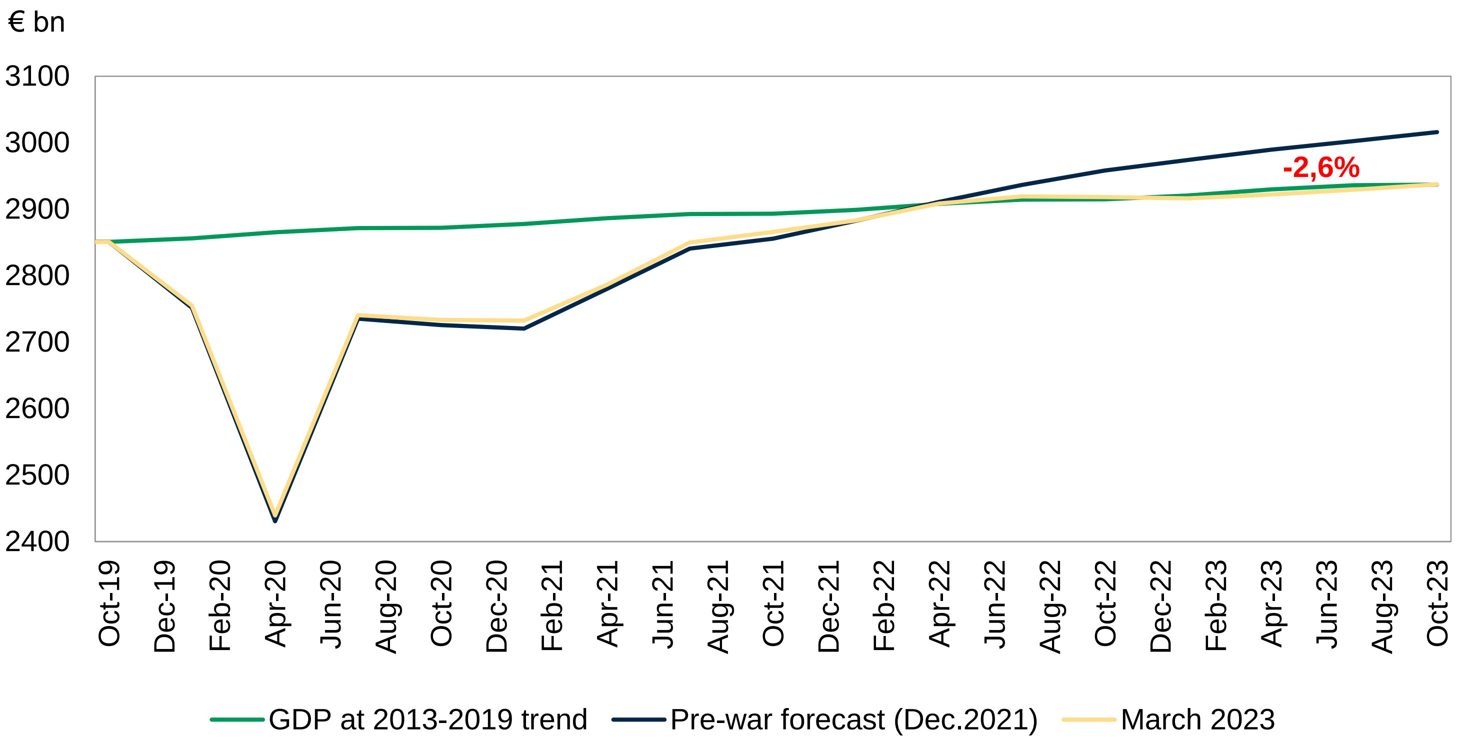


Sources: Bruegel, Crédit Agricole S.A./ECO

THE IMMEDIATE AND PROLONGED IMPACT OF THE SHOCK ON GROWTH

STRUCTURAL WEAKENING

Jeopardising medium-term growth



Sources: Crédit Agricole S.A./ECO

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DECEPTIVE RESILIENCE?

GDP growth in fourth-quarter 2022 was only marginally negative (-0.03%), but domestic demand deteriorated with a decline in private consumption (-0.9% for the quarter) and investment (-0.6% excluding the emphatic correction in Ireland).

Housing investment is down (-1.6%), **as is investment in machinery, equipment, and transport equipment.** The only sector not to slip in the fourth quarter was construction, which merely stagnated. The capital formation trend came to a sudden halt in Germany and Spain, both in construction and business investment. If GDP growth was not more negative, it is due to the positive contribution from net exports owing to a contraction in imports stemming in particular from a return to normal in energy purchasing behaviour.

The household savings rate (14.1% in Q4 2022 after 13.3%) bucked the downward trend in place for a year and a half. The acceleration in gross disposable income (2.2% for the quarter after 2%) thus failed to translate into stronger consumption growth (1.3% in value after 2.3%). Consumption dipped 0.9% in volume. Disposable income rose less than inflation (measured by the household consumption deflator) and purchasing power deteriorated (-0.4%). Households also invested less, their investment rate falling for the third consecutive quarter to 9.7%. This failed to reverse the decline in financing capacity, with the financial savings rate decreasing to 4.1% (after 4.3%). The result was a decline both in financial investment and in debt, with a slowdown in credit flows (3.7% year-on-year after 4.2%). The share of financial wealth decreased more than that of their liabilities (with debt at 57.2% of GDP) leading to lower net wealth (in GDP points). Property wealth also declined.

Non-financial corporations significantly improved their margins in Q4 2022 (42% after 40.4%). Despite the acceleration in wage increases (2.1% after 1.5%), the decline in other taxes net of subsidies contributed to an increase in gross operating income. Despite realised profits, the investment rate declined to 23.5% (after 25.4%). Enhanced financing capacity failed to boost financial investment, which trended downwards with a decrease in the accumulation of deposits. Financing also declined, with a sharp contraction in credit flow growth (from 6% to 4.4% year-on-year). The debt ratio fell to 74.8% from 79.1% a year ago.

We expect **a further modest decline in domestic demand in first-quarter 2023 (-0.1%), fuelled by a further, though more modest, slowdown in household consumption.** Difficult-to-predict adjustments in imports and inventories remain possible and could likely shake up the growth forecast in early 2023, positively and negatively.

DECEPTIVE RESILIENCE?

Surveys showed that eurozone economic activity accelerated for the fifth month in a row in March after troughing in October. The initial estimate of the composite PMI stands at 54.1 points after 52 in February.

Production and orders are picking up, with the latter now as high as before the Ukraine conflict. But foreign demand is contracting, though at a slower pace. The future outlook for production is still improving, but again at a slower pace. Hiring intentions are strengthening.

However, this overall performance masks a further contraction in the manufacturing sector, a trend that is accelerating after rising moderately over four months. The manufacturing PMI fell to 47.1 points in March after 48.5 in February. Manufacturing has not grown since June 2022 and the deterioration in orders has accelerated, with the exception of those from abroad.

Supply constraints are easing quickly with a substantial reduction in supply delivery time and a sharp decline in the accumulation of pending work. This also corresponds to a decline in corporate demand for inputs. Inventories of finished products have stabilised over the last two months after falling from extremely high levels over a six-month period. While this decline made the level of inventories more consistent with demand, **the decrease in orders may suggest further inventory reductions in the future, which could weigh on production**. However, the outlook for production remains positive, though the pace of improvement is weakening.

Industrial production recovered strongly with another positive increase of 1.5% over the month, returning to summer 2022 levels after the contraction in the autumn. The performance of energy-intensive sectors has proved less impressive, with production continuing to decline, albeit at a more moderate pace.

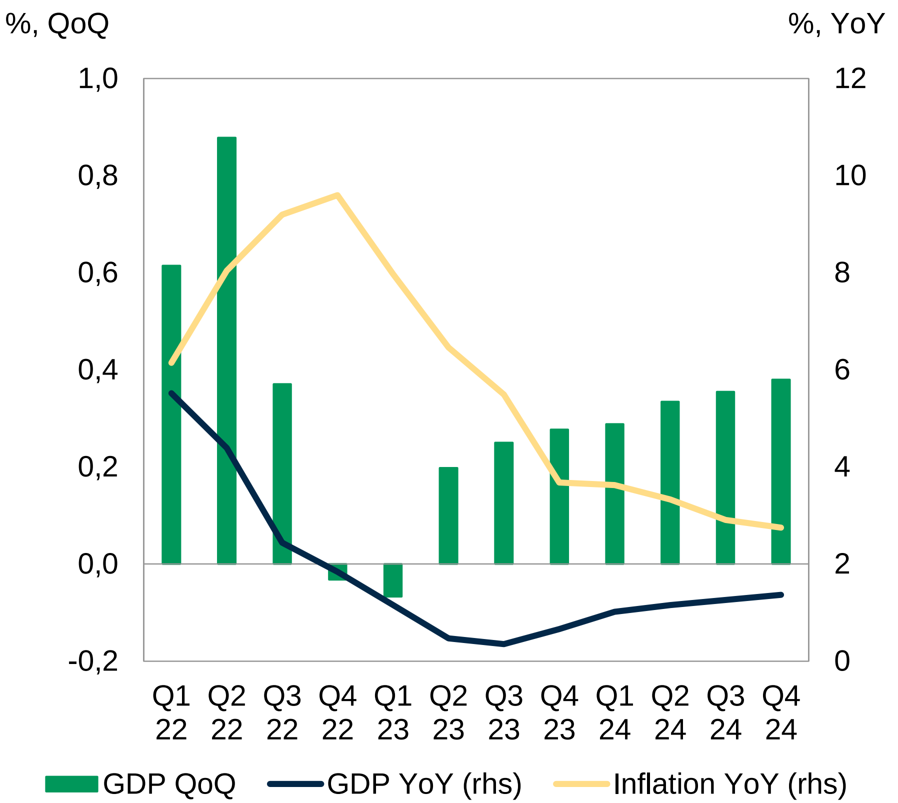
Lower demand and fewer supply constraints have resulted in the first drop in input prices since summer 2020. But selling prices continue to rise, though more slowly, allowing further margin building.

This gap, and the attendant increase in margins, is particularly substantial in the services sector, where input prices continue to slide on persistently stronger activity. **The services PMI stood at 55.6 points in March after 52.7 in February, with all the components of the index accelerating except for prices.**

THE TRANSITION FROM RESILIENCE TO THE END OF EXPANSION

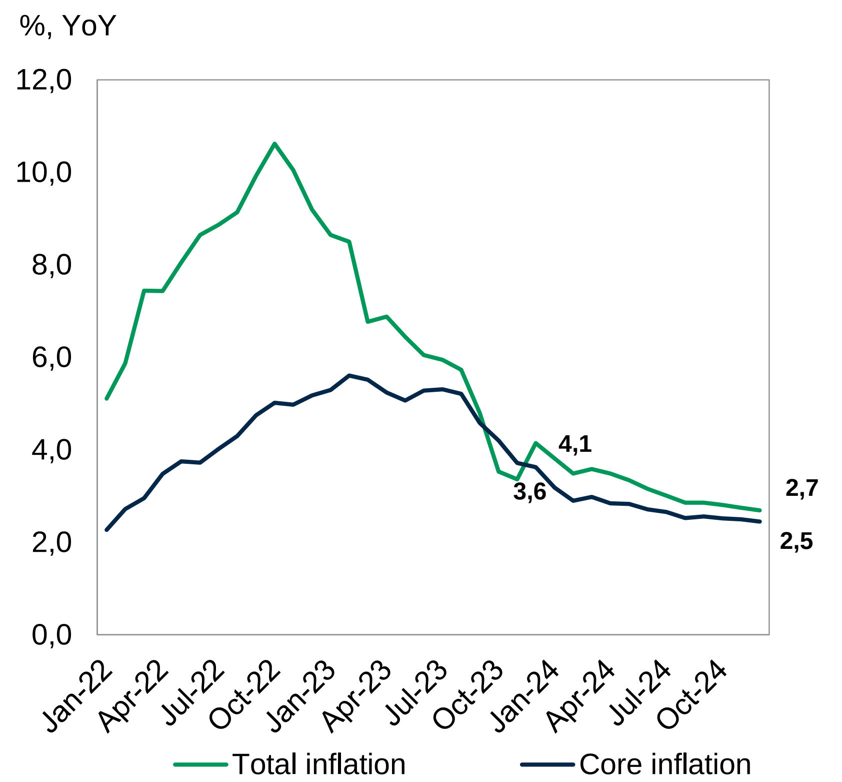
DRIVEN BY INFLATION AND MONETARY POLICY

Growth scenario dominated by inflation



Sources: Eurostat, Crédit Agricole S.A./ECO

Inflation lower but more persistent in its less volatile components

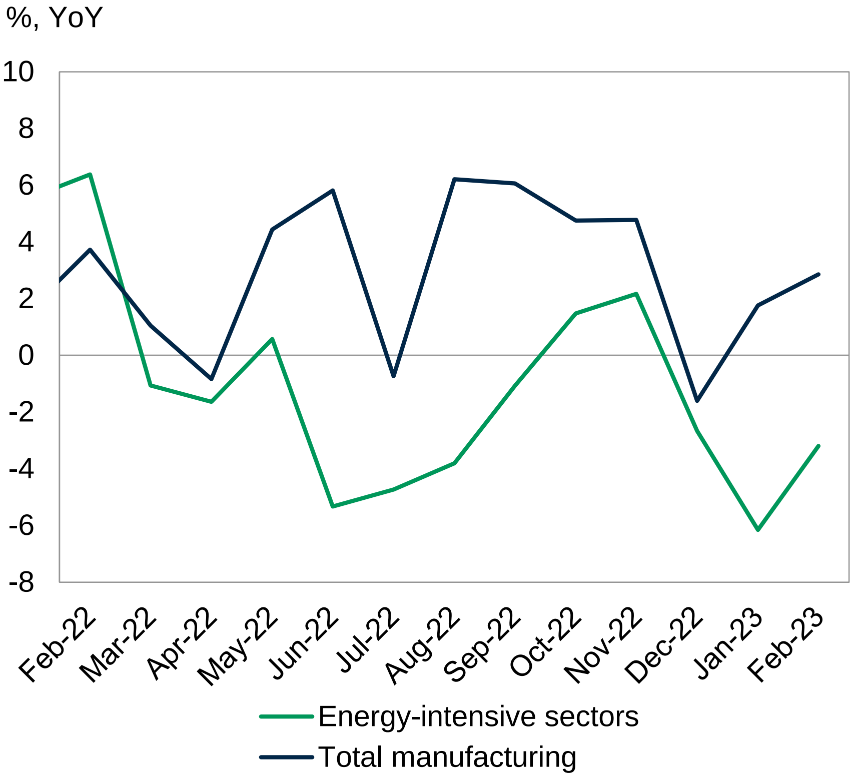


Sources: Eurostat, Crédit Agricole S.A./ECO

THE TRANSITION FROM RESILIENCE TO THE END OF EXPANSION

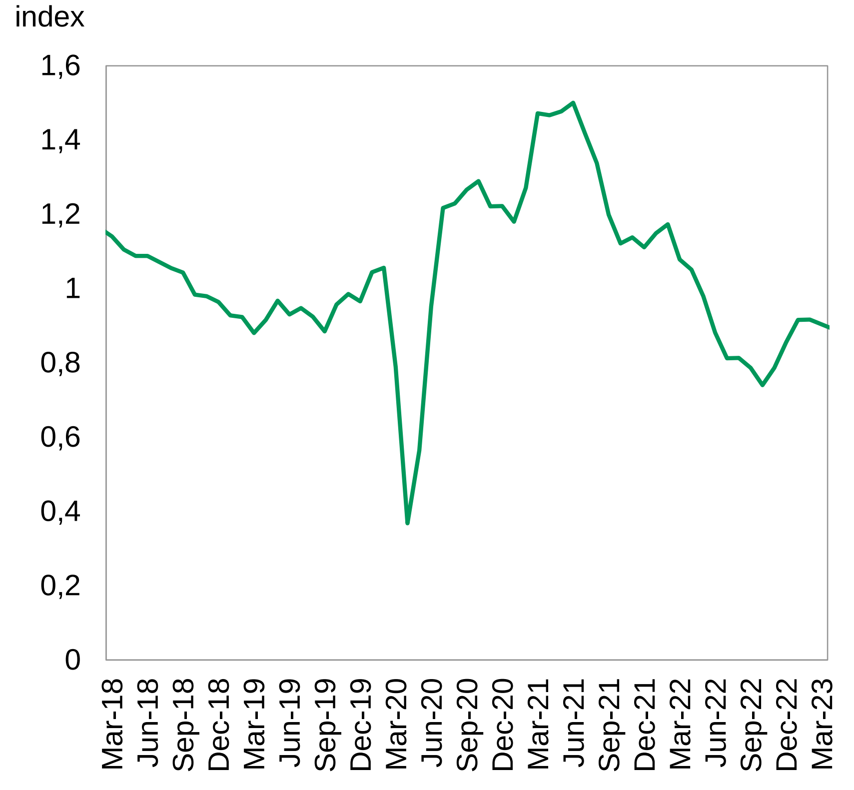
STRONGER ACTIVITY, DOUBTS OVER MANUFACTURING

Industrial output



Sources: Eurostat, Crédit Agricole S.A./ECO

Industry: orders-to-inventories ratio



Sources: Markit, PMI, Crédit Agricole S.A./ ECO

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THEMES OF THE SCENARIO

PRIVATE-SECTOR VIGOUR CHALLENGED

According to our scenario, GDP growth will be positive though modest, accelerating slightly from mid-2024 onwards. Two opposing factors explain this positive but timid growth, which will still not have returned to its potential rate by the end of 2024. The **decline in inflation** is restoring household purchasing power, but the **rise in interest rates** is having an increasing impact on investment.

For companies, the impact of monetary policy has been fully reflected in rates to bank customers. The latest BLS survey indicates a tightening of credit conditions and a decline in credit demand, mainly due to the downturn in investment. The fall in input prices and European funds should nevertheless support business investment, offsetting the weakening of housing investment and allowing a gradual but modest strengthening of capital accumulation. The economic and financial situation of non-financial companies remains strong and the number of defaults remains below pre-COVID levels, except in Spain. Defaults remain limited to the sectors most affected by the pandemic.

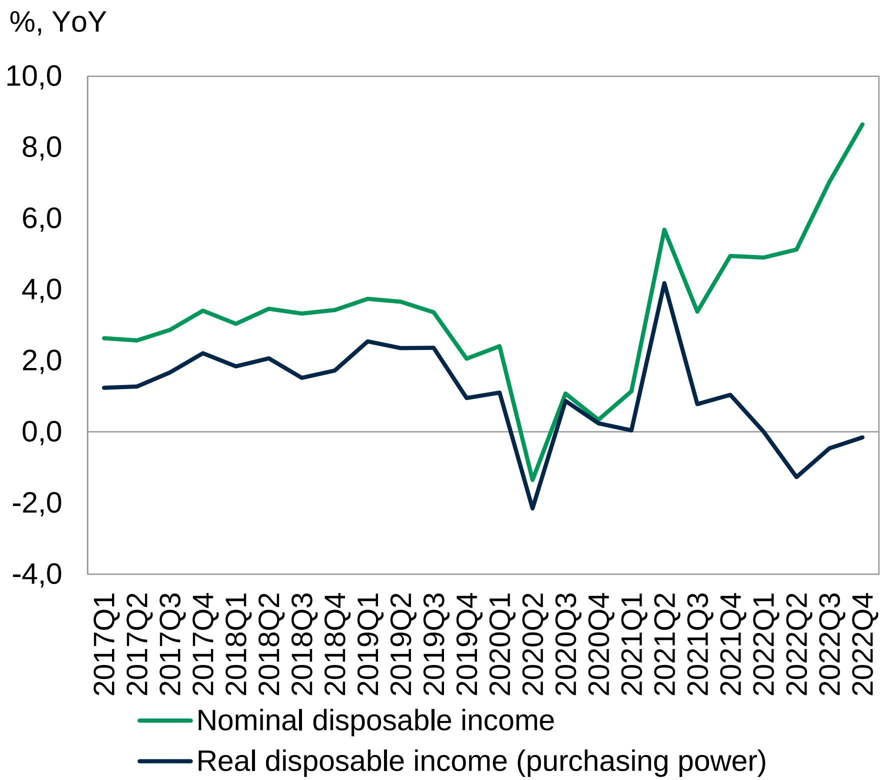
For households, the tightening of credit conditions is more emphatic for households and mortgage demand is dropping substantially in its most extreme downward trend since 2003. **Private consumption looks set to return to positive growth, but below the average for 2015-2019.** It will draw on growth in real disposable income that should return to positive territory beginning in the second quarter of 2023. Household income was supported by robust growth in earned income, but also by social benefits and transfers, both of which almost offset the negative effect of inflation. In Q4 2022, household income purchasing power fell by a limited 0.6% year on year in the eurozone and 0.4% in France. Real income rose once again in Germany and the Netherlands but slipped in Italy and, above all, in Spain, where the rate of progression of nominal disposable income is weaker.

The savings rate is now lower then before COVID in all the major eurozone economies, but it has fallen more substantially in Spain and, to a lesser extent, Italy. However, the excess savings accumulated since the pandemic continue to increase. **In our scenario, the availability of these surplus savings, if they were to be drawn on more quickly, constitutes a bullish risk.**

HOUSEHOLD DISPOSABLE INCOME UP SHARPLY

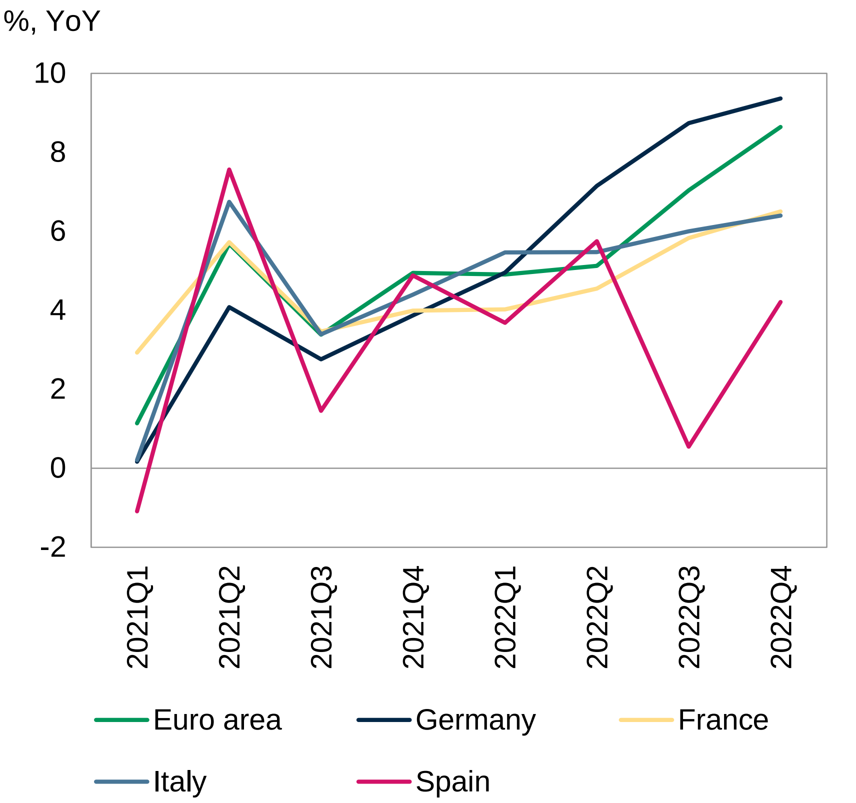
BUT PURCHASING POWER DOWN

Household disposable income and purchasing power



Sources: Eurostat, Crédit Agricole S.A./ECO

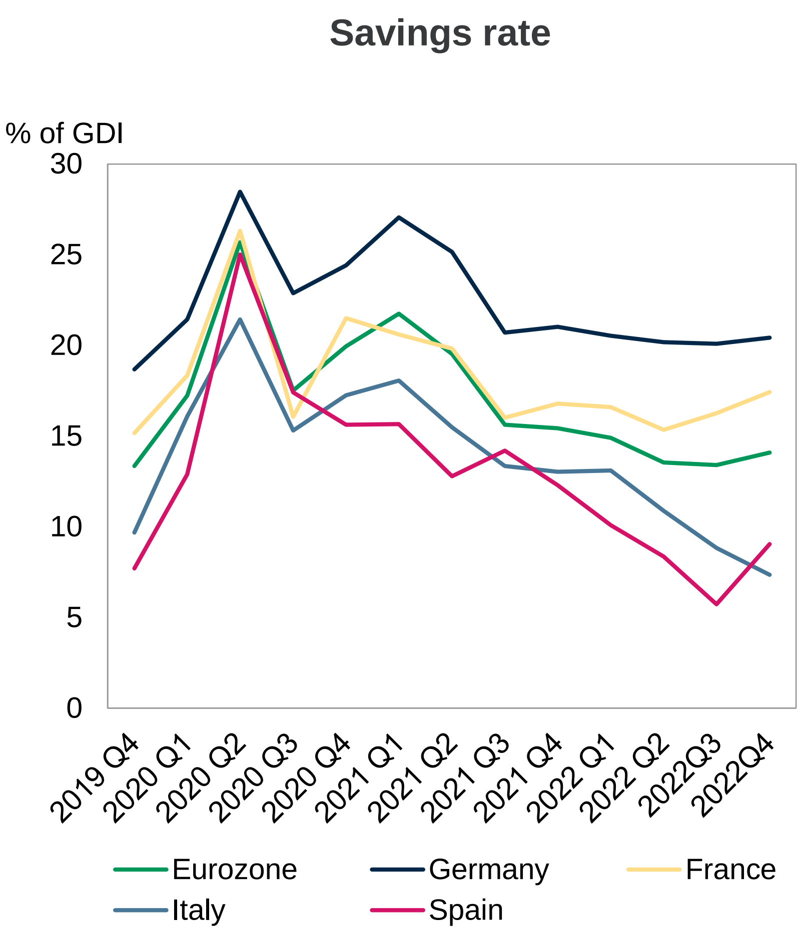
Real disposable income by country



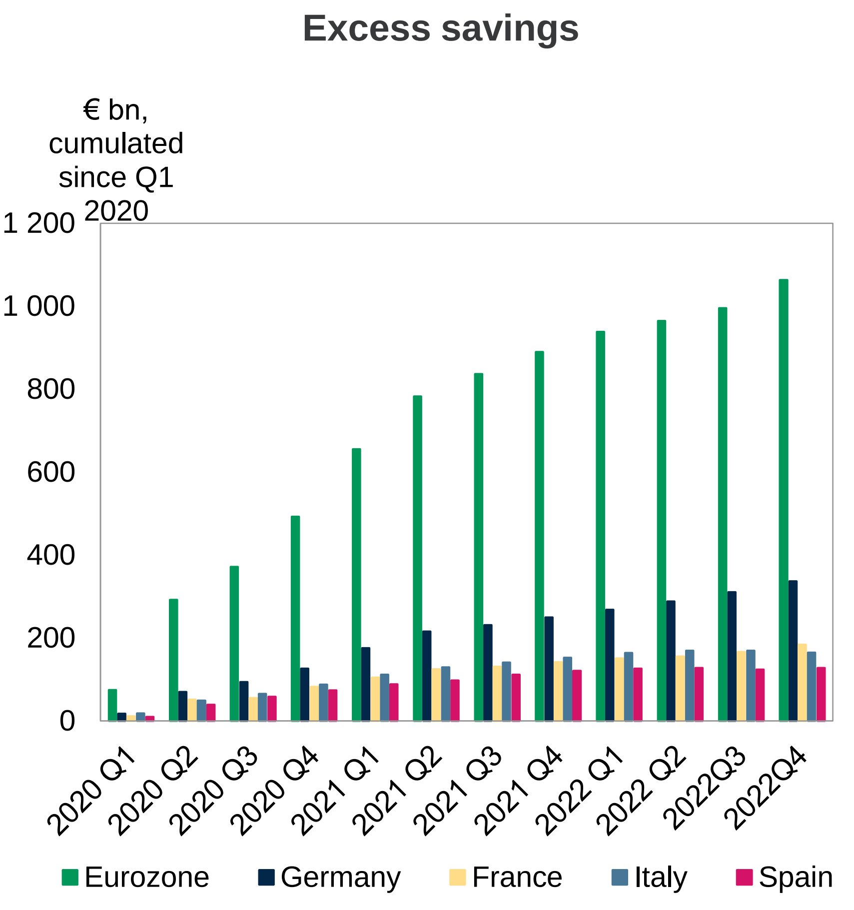
Sources: Eurostat, Crédit Agricole S.A./ECO

HOUSEHOLDS: THE NORMALISED SAVINGS RATE IS RISING AGAIN

EXCESS SAVINGS CONTINUE TO INCREASE, BUT NOT EVERYWHERE



Sources: Eurostat, Crédit Agricole S.A./ECO

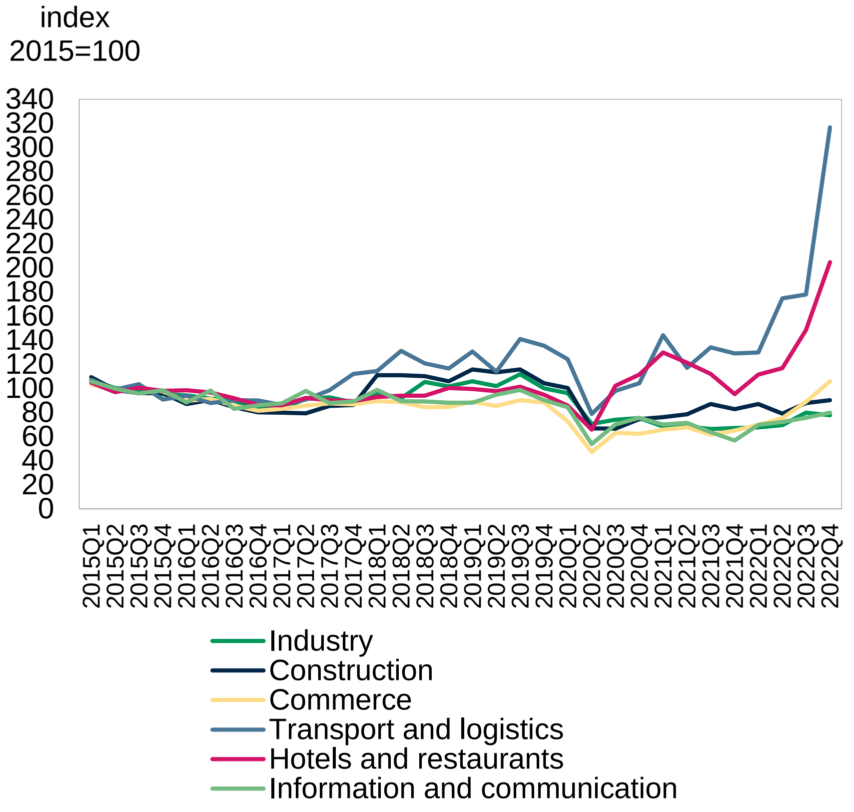


Sources: Eurostat, Crédit Agricole S.A./ECO

COMPANIES: DEFAULTS ON THE RISE

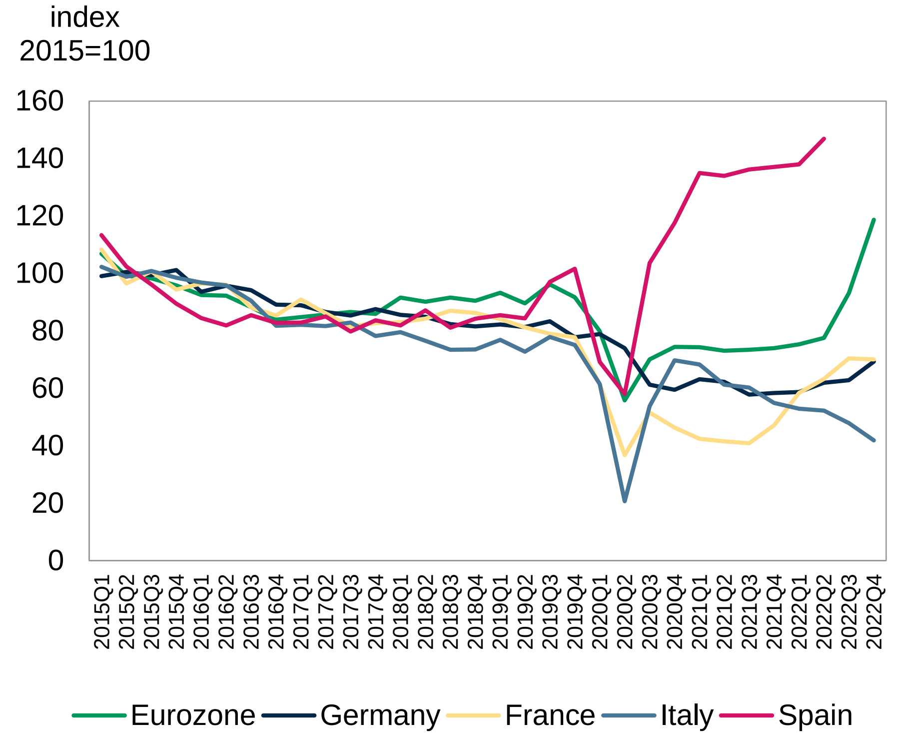
THOUGH NOT YET A CAUSE OF CONCERN

Eurozone: bankruptcies by sector



Sources: Eurostat, Crédit Agricole S.A./ECO

Bankruptcies by country



Sources: Eurostat, Crédit Agricole S.A./ECO

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FOCUS: INFLATION AND ITS NEW DRIVERS

THE DELAYED TRANSMISSION OF SHOCKS AND RENEWED PRICING POWER

The inflation rate fell sharply in the eurozone in March, from 8.5% to 6.9% year-on-year. This came as no surprise, since we expected the role played by the base effect of the sharp increase in March 2022, linked to the acceleration of the energy component. The energy component of the index was down in March for the first time in two years (-0.9% after 13.7% year-on-year). Also unsurprisingly, core inflation continued to rise (5.7% after 5.6% in February). **The acceleration in prices of services and food (processed and otherwise) offset the slowdown in the prices of non-energy industrial goods.** The downward trend in energy import prices in place since September 2022 accelerated sharply in January, combined with a decline in the (highly energy-sensitive) prices of imported intermediate goods and the easing of constraints on global value chains and maritime traffic. This decrease has not been fully passed on to energy production prices and, more generally, to production prices in manufacturing, which could be a sign of opportunistic margin behaviour. However, the decline has already generated a decrease in consumer prices for housing and energy distribution services.

The conclusion that can be drawn from these contrasting developments is that the decline in energy-related inflation is spreading to all the other components but the transmission of its previous rise to the prices of other goods and services and wages is generating an inertia that makes inflation more persistent. So inflation should not be expected to dip substantially in the coming months, but this short term will not impede the downward trend. Another major base effect on energy prices is expected in June, which could once again lead to a more marked slowdown in the price index.

Most indicators suggest that we have already reached the peak of the inflationary shock. Natural gas prices seem to have reached a “new normal” at less than €100 per megawatt hour (averaging €75/MWh in 2023 and €90 in 2024 in our forecast), well below the historical peak (€340/MWh) but above the historical average (€18/MWh). The recent stabilisation of natural gas prices is the (precarious) result of a number of one-off events; however, the factors that could push these prices up are still present.

The fall in inflation is driven entirely by the fall in the energy component. **The rise in the other components continues to be caused by the delayed effects of the passing on of energy costs.** This is especially true for processed foodstuffs, which saw higher prices in mass market retail in several countries at the beginning of the year. This is also true for services, where wages have risen rapidly, and this is being reflected in list prices. But it is less true for the prices of non-energy industrial goods, which continue to be affected by the knock-on effects of past increases in energy prices but have benefited from the easing of supply chain issues and the appreciation of the euro. **We therefore expect inflation to fall to an average 5.9% in 2023 and 3.1% in 2024. Core inflation will remain high at an average 4.9% in 2023 and 2.7% in 2024.**

FOCUS: INFLATION AND ITS NEW DRIVERS

THE DELAYED TRANSMISSION OF SHOCKS AND RENEWED PRICING POWER

While the ECB continues to monitor core inflation, other economic agents are responding to the trend in headline inflation. As a result, **price expectations have been falling since November for companies in the manufacturing, construction and retail sectors, while the decline is more recent in services**, according to the European Commission survey. **These trends are consistent with those indicated by the PMIs, which confirm a deceleration in input prices.** In manufacturing, input prices even declined for the first time since summer 2020, while selling prices continue to rise, albeit more slowly, allowing margins to be built up further. This gap – and the resulting increase in margins – is even wider in the services sector, where input prices have decelerated across the board.

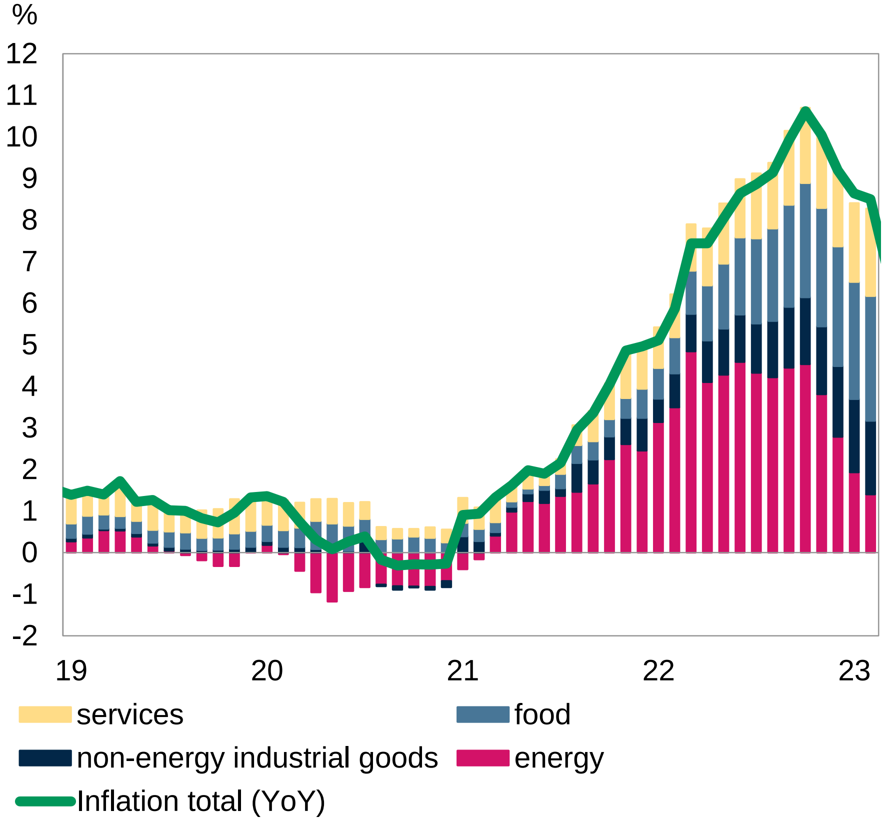
This strengthening in the pricing power of eurozone companies and the opportunistic behaviour facilitated by relative price volatility were clearly reported in sector accounting data in Q4 2022 on corporate margins.

In terms of consumers, the Commission's latest surveys in March point to a reversal in the recent downward trend in price expectations, probably influenced by the rise in food prices. The ECB's latest survey of consumer expectations in January continued to point to expectations considerably lower than recent perceived inflation, with the latter expected to decline to 4.9% in one year and 2.5% in three years. This contrasts with the upward revision to inflation expectations for professionals in 2023 and 2024 according to the ECB's Q1 2023 survey. This finding is consistent with that of the ECB survey of monetary analysts for 2024. In both cases, **longer-term inflation expectations remain anchored to the ECB target (respectively 2.1% and 2%). However, the market's five-year inflation expectations rose again to 2.58%. The ECB will continue to monitor these forecasts but will keep a close eye on margin trends, pointing to second-round effects that could make inflation more persistent.**

INFLATION DECLINE HINDERED BY INERTIA

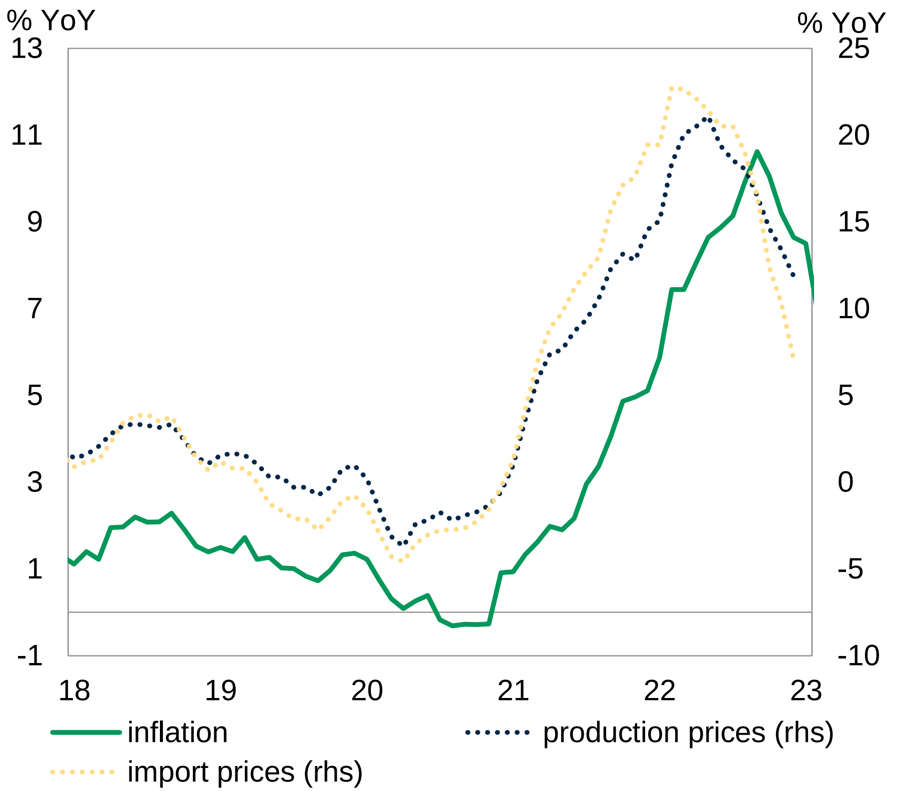
FROM EXTERNAL DRIVERS TO DOMESTIC DRIVERS

Contributions to growth in the consumer price index



Sources: Eurostat, Crédit Agricole S.A./ECO

Lower global inflation passed on to domestic consumer prices

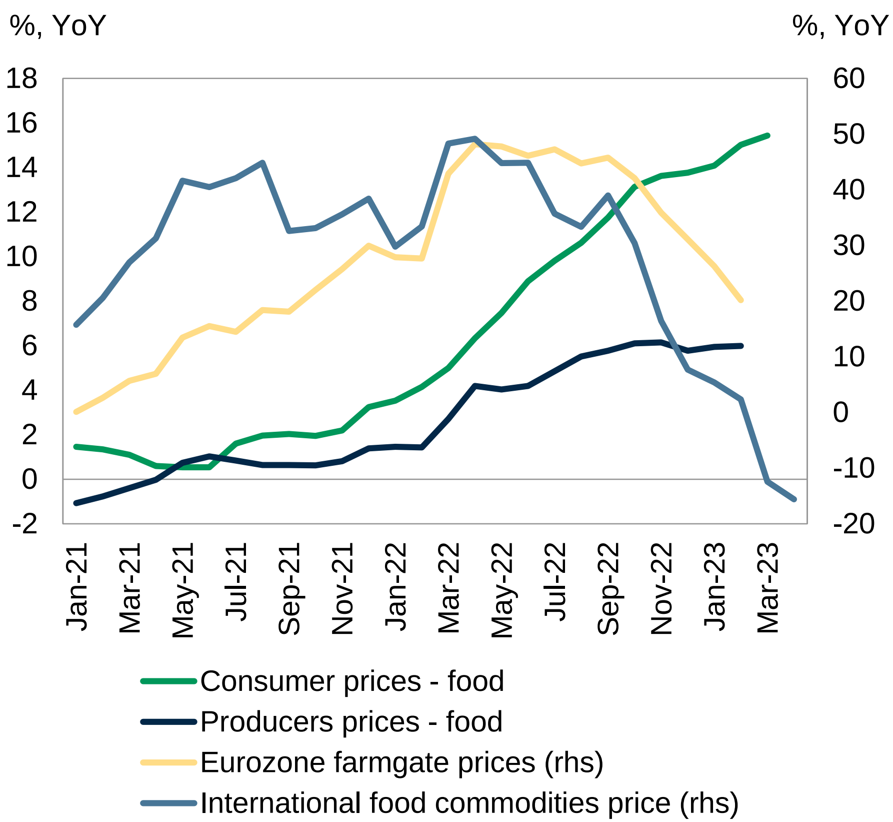


Sources: Eurostat, Crédit Agricole S.A./ECO

CLEARLY VISIBLE SECOND-ROUND EFFECTS

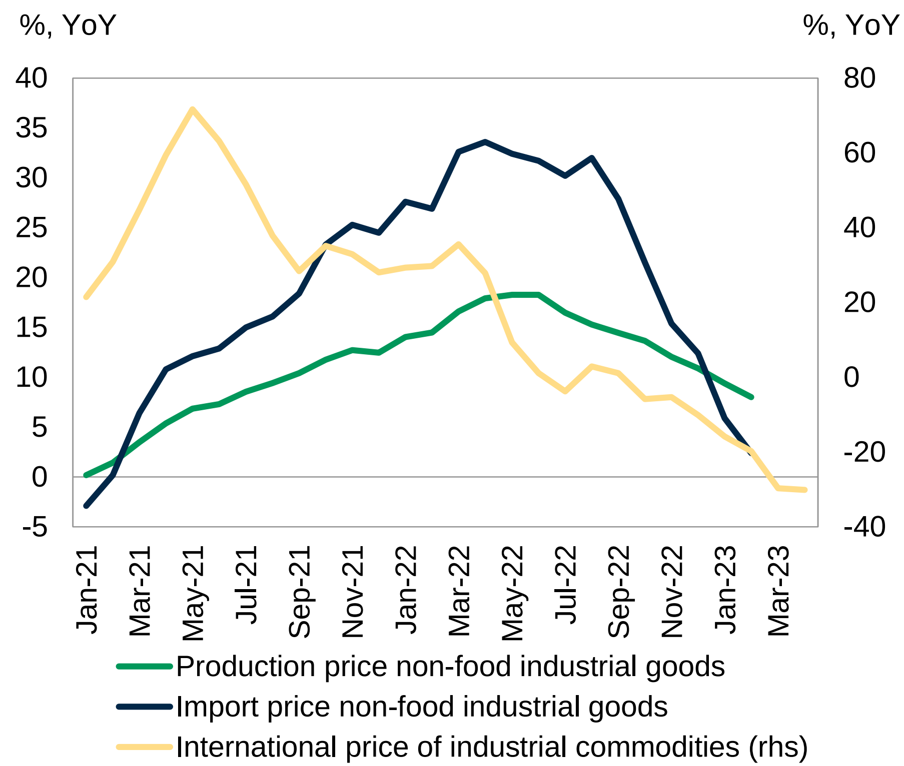
BUT THE DECLINE IS IN THE "PIPELINE"

In the pipeline: food prices



Sources: Eurostat, HWWI, Crédit Agricole S.A./ECO

In the pipeline: prices of non-food industrial goods



Sources: Eurostat, HWWI, Crédit Agricole S.A./ECO

FOCUS: INFLATION AND ITS NEW DRIVERS

EMPLOYMENT, PRODUCTIVITY AND THE WAGE MINI-CYCLE

Wage pressure is increasing, with effective wages having accelerated in the fourth quarter of 2022 (5.4% year-on-year). This trend is being driven mainly by the services sector (excluding trade, transport and accommodation), while a slowdown is visible in construction and industry.

The minimum wage increase made a substantial contribution in 2022 (with year-on-year minimum wage growth of 8% in Germany, 6% in France and 5% in Spain in the second half of the year). **The increase in effective working hours has also contributed. The negotiated component of wages was more modest, with one-time bonuses making up for past losses in purchasing power. Wage momentum generated by negotiations was more modest but picked up at the end of the year. We expect per capita wages to accelerate to 5.1% in 2023 (after 4.8% in 2022) before slowing to 3.8% in 2024 with a smaller contribution from increases in the minimum wage, hours worked, and bonuses.**

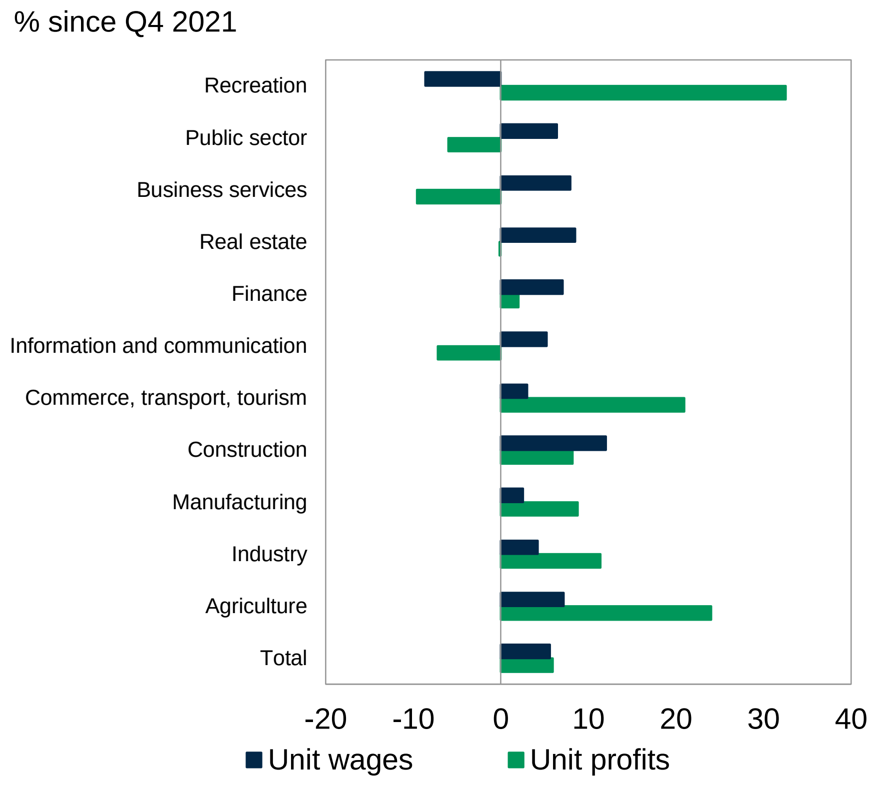
Second-round effects are particularly visible in trends in corporate margins, which indicate a strengthening of companies' pricing power in the eurozone and opportunistic behaviour facilitated by the volatility of relative prices.

Margins are back to the peak of late 2017: high and rising in industry (especially at energy producers) and financial services, to a lesser extent in construction, while they are already falling in trade and other non-financial services. But the slowdown in the productivity cycle is already evident. **We expect weakening productivity to drag down profits and limit the potential for wage increases.** However, **employment will remain resilient with a limited increase in unemployment and some recourse to short-time work** (already happening in certain sectors).

A NEW RISK FACTOR

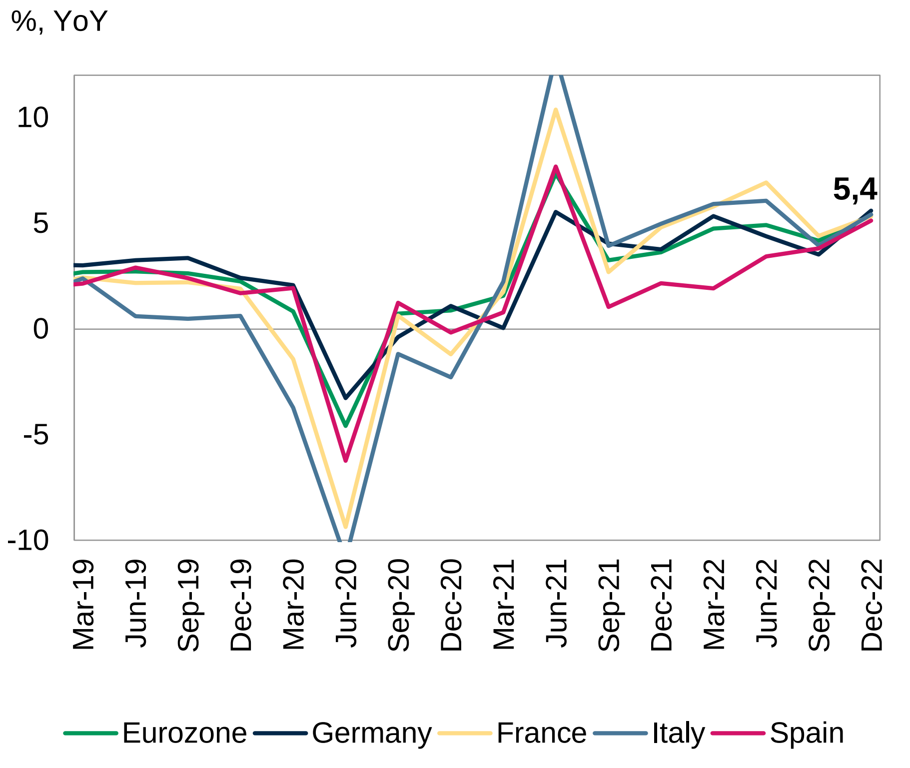
PROFITS MORE THAN WAGES

Profits higher than wages



Sources: Eurostat, Crédit Agricole S.A./ECO

Actual wages

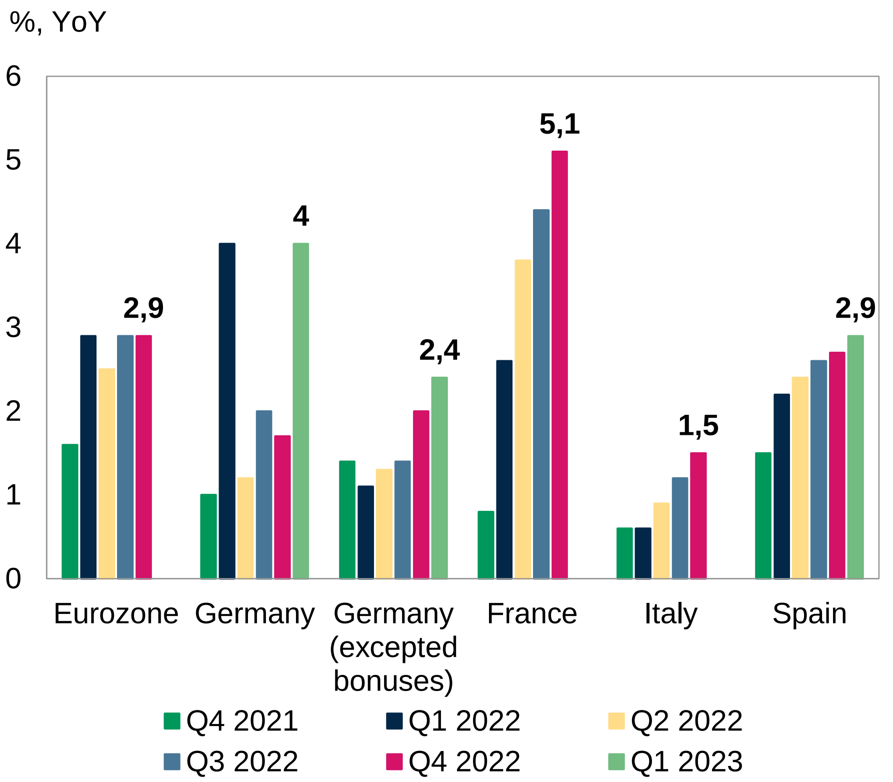


Sources: Eurostat, Crédit Agricole S.A./ECO

REAL WAGES ARE RECOVERING

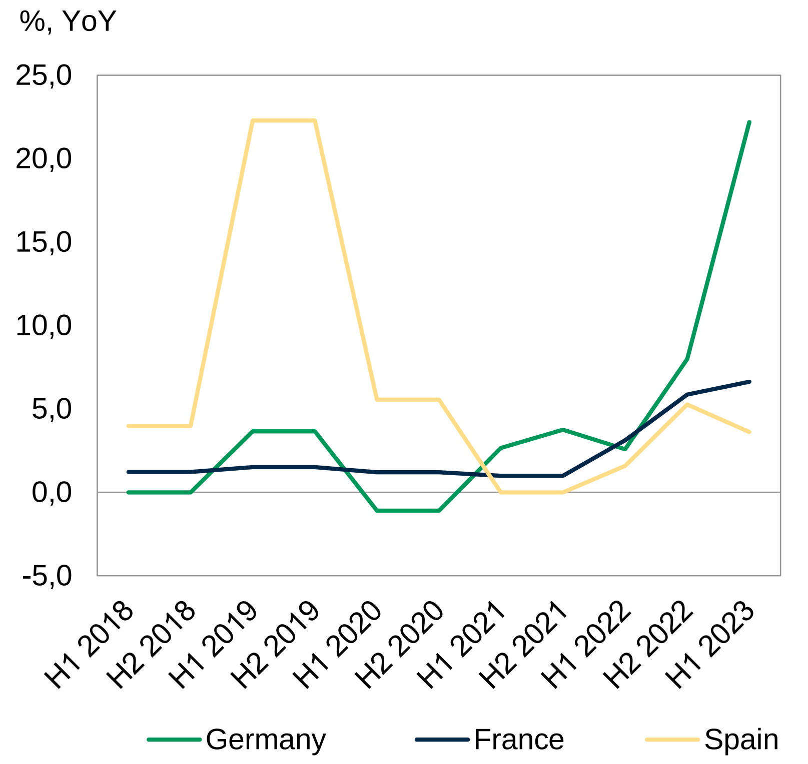
DRIVERS ARE WEAKENING

Negotiated wage



Sources: BCE, Destatis, Banque de France, Istat, Ministerio de trabajo, CASA/ECO

Minimum wage



Sources: Eurostat, Crédit Agricole S.A./ECO

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A PRO-CYCLICAL POLICY MIX ON TWO FRONTS

MONETARY AND FISCAL POLICY ACCENTUATE RESTRICTIONS

While the ECB continues to see the unmooring of inflation expectations and the triggering of a price-wage spiral as the biggest risk of inflation drifting away from its target, it has also said that it is paying close attention to the trend in profits. At its last meeting in March, the ECB raised its key interest rates by 50 basis points, bringing the refinancing rate to 3.5% and the deposit rate to 3%. Above all, it has strengthened its data-driven approach by more explicitly revealing its reaction function. **Future ECB policy will depend on three factors**: its assessment of the inflation outlook based on available macroeconomic and financial data; the trend in core inflation; and the strength of monetary policy transmission. The clarification of the reaction function reduces the opportunity for the more aggressive members of the Governing Council to speak out and pre-commit the ECB to a rate hike path. **The ECB has nevertheless said that future rate hikes would be inevitable if its central inflation scenario were to become reality and uncertainty were to reduce.**

Fiscal policy remained rather neutral in 2022, partly offsetting the tightening of monetary policy. The improvement in deficits is mainly due to inflation, which has generated windfall revenues, partly used to finance measures to counter the impact of inflation and replace post-Covid measures. However, the European Commission has recently provided guidance on the application of fiscal supervision in 2023 and 2024 pending a legislative agreement on governance reform. **The excessive deficit procedures will be applied from 2024 onwards on the basis of 2023 budgetary outcomes.** The Commission recommends that countries be more responsible in controlling current expenditure with an obligation coupled with a constraint. The aim is to reduce, but also quickly target, support measures linked to the rise in energy costs while avoiding any unjustified support for demand that could hamper the transmission of monetary policy. Countries will therefore be forced to scale back the scope of their energy-related support measures, with pressure mounting for tighter control of current spending. The new guidelines link debt reduction trajectories to those for total expenditure while forcing states to commit to their investment expenditure. **Fiscal stimulus will therefore be negative in 2023 (0.8 points of GDP) and 2024 (0.7 points).**

ECB: PRIORITY ON PRICE STABILITY BUT...

… WITH FINANCIAL STABILITY AT THE FOREFRONT

- **New reaction function “unveiled”**

Future ECB policy will depend on three factors:

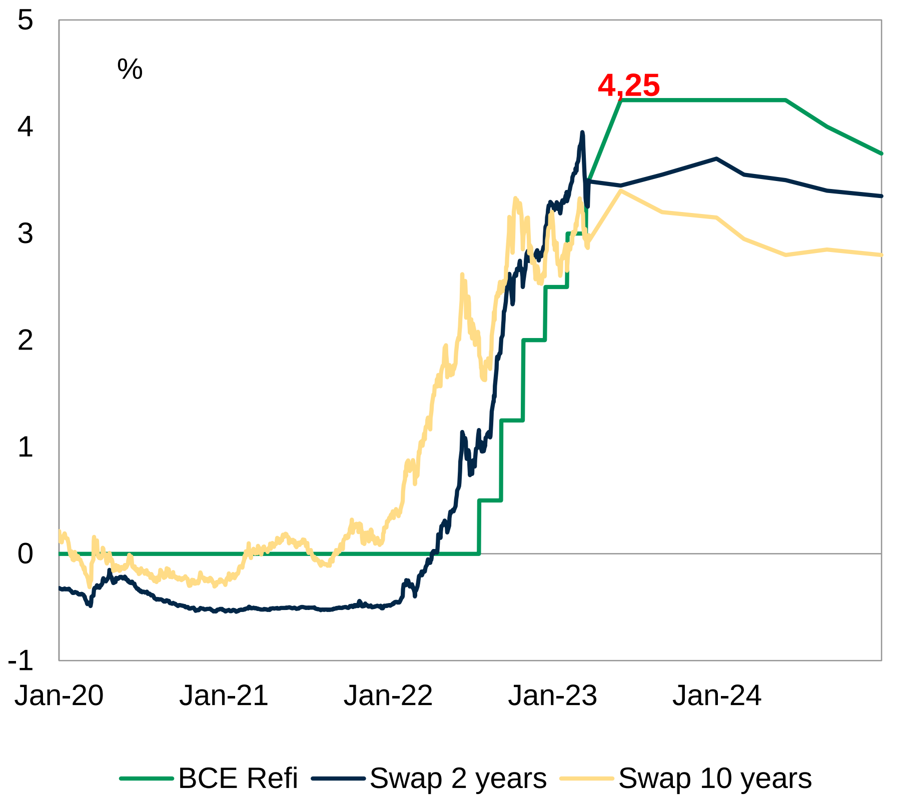
- its assessment of the inflation outlook based on available macroeconomic and financial data;
- the trend in core inflation (excluding volatile components);
- the power of monetary policy transmission.

- **Separation principle affirmed**

ECB: FOCUS ON FIGHTING INFLATION

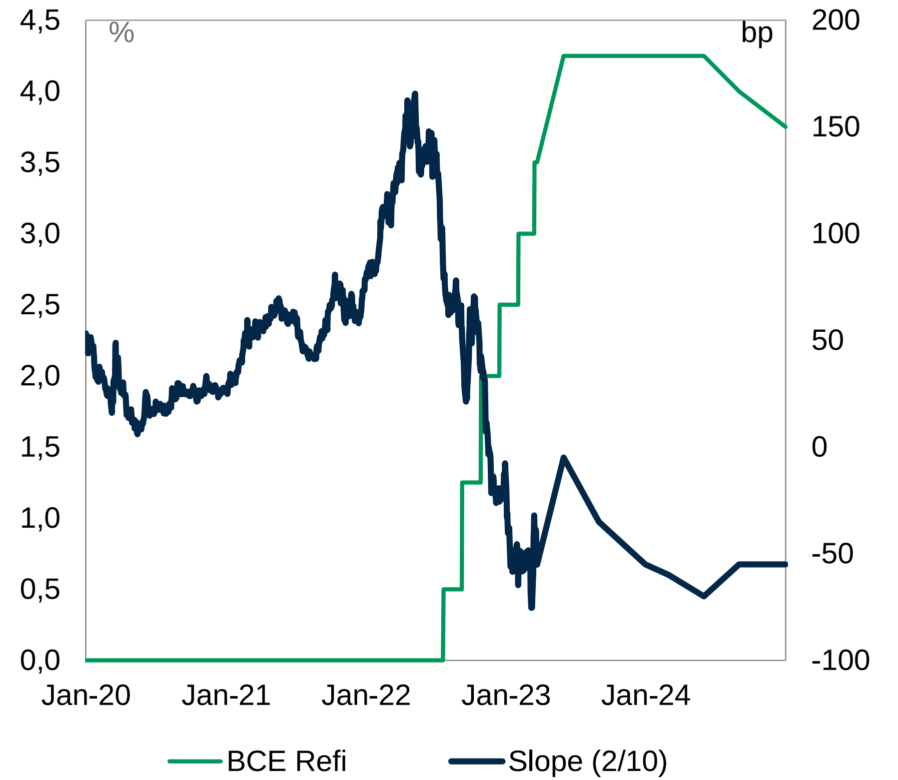
MONETARY TIGHTENING: A LITTLE MORE PATIENCE

ECB scenario and swap rate



Sources: Bloomberg, CACIB, Crédit Agricole S.A./ECO

Eurozone – slope reversed

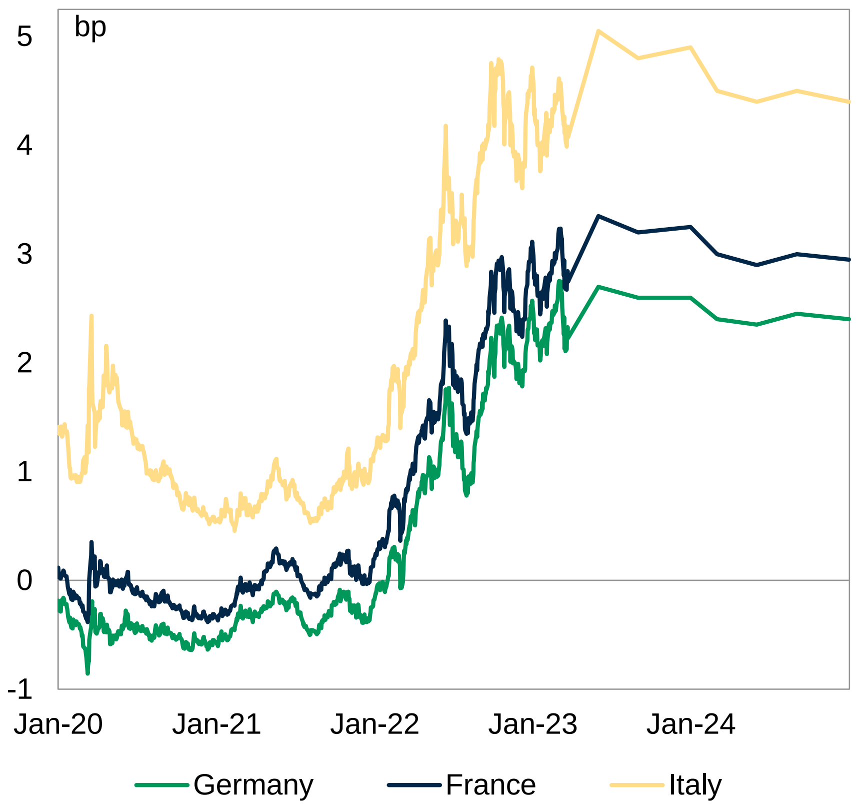


Sources: Bloomberg, CACIB, Crédit Agricole S.A./ECO

LONG INTEREST RATES

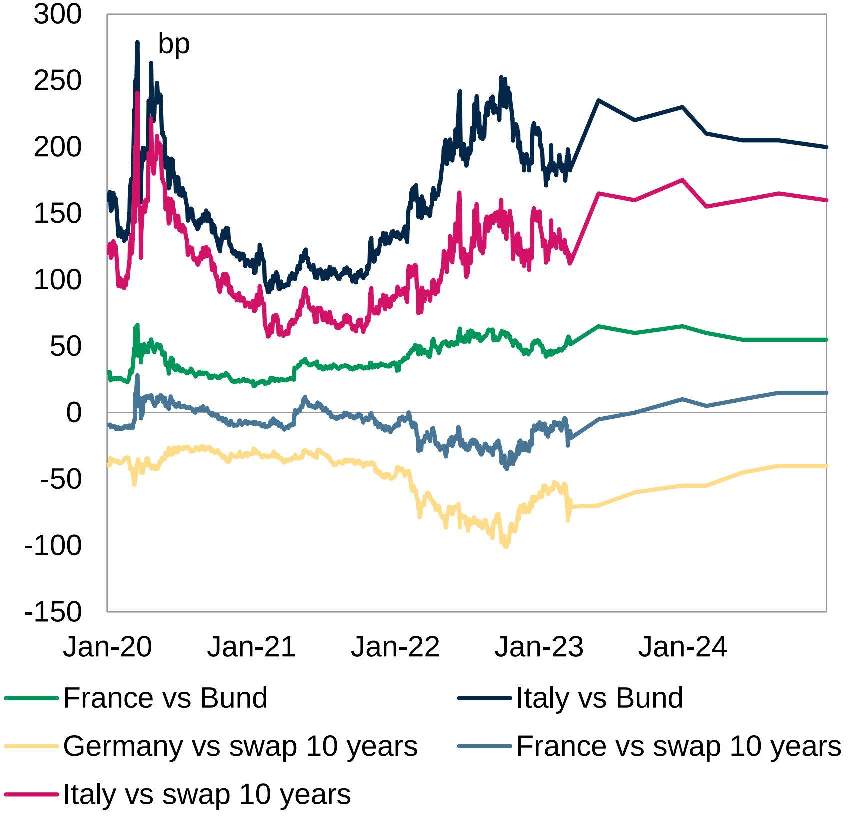
INCREASE HAMPERED BY THE EXPECTED DECLINE IN INFLATION AND GROWTH

Eurozone – 10-year sovereign rates



Sources: Bloomberg, CACIB, Crédit Agricole S.A./ECO

Spreads/Bund and /Swap



Sources: Bloomberg, CACIB, Crédit Agricole S.A./ECO

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