EUROZONE
2022-2023 SCENARIO

AN IMMEDIATE, LASTING AND DOUBLY ASYMMETRIC COMPETITIVE SHOCK

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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SUMMARY

A STRUCTURAL COMPETITIVENESS SHOCK THAT AFFECTS POTENTIAL GROWTH

The Russia-Ukraine conflict and the resulting disorderly energy crisis has triggered a structural competitiveness shock in the Eurozone: an immediate, lasting, and doubly asymmetric shock. By its nature, it impacts Europe more than other advanced economies, but it is affecting European countries differently too. Assessment of the shock includes higher prices for energy imports in 2022 than 2021, some of which have already materialised. In line with the assumption of a drawn-out conflict, the assessment of this shock also includes limited Russian gas supply (stabilising at levels seen last July) and gas prices that will exceed €200 per megawatt/hour (MWh) for a significant period. The cost of this shock in terms of GDP could reach an estimated 6 points in 2022 and 3 additional points in 2023.

The impact on the Eurozone economy is already apparent and reflected in the successive downgrades to our scenario since March. **Our Eurozone GDP forecast for the end of 2023 is 3.2% lower than the level forecast in our December 2021 scenario, before the invasion of Ukraine.**

The Eurozone economy reached a turning point in the middle of the year. First-half growth was solid on the back of the post-Omicron rebound and high levels of consumer spending on services, purchasing power bolstered by robust wage growth and government measures to mitigate the impact of rising prices. The growth carry-over for 2022 was 3.2% at the end of the first half, which warranted **the increase in our 2022 growth forecast from 2.5% (July 2022) to 3.2%**. However, **over the summer, the threat of limited Russian gas supply materialised, prices soared, and "energy" inflation gradually spread into the other components of the price index.**

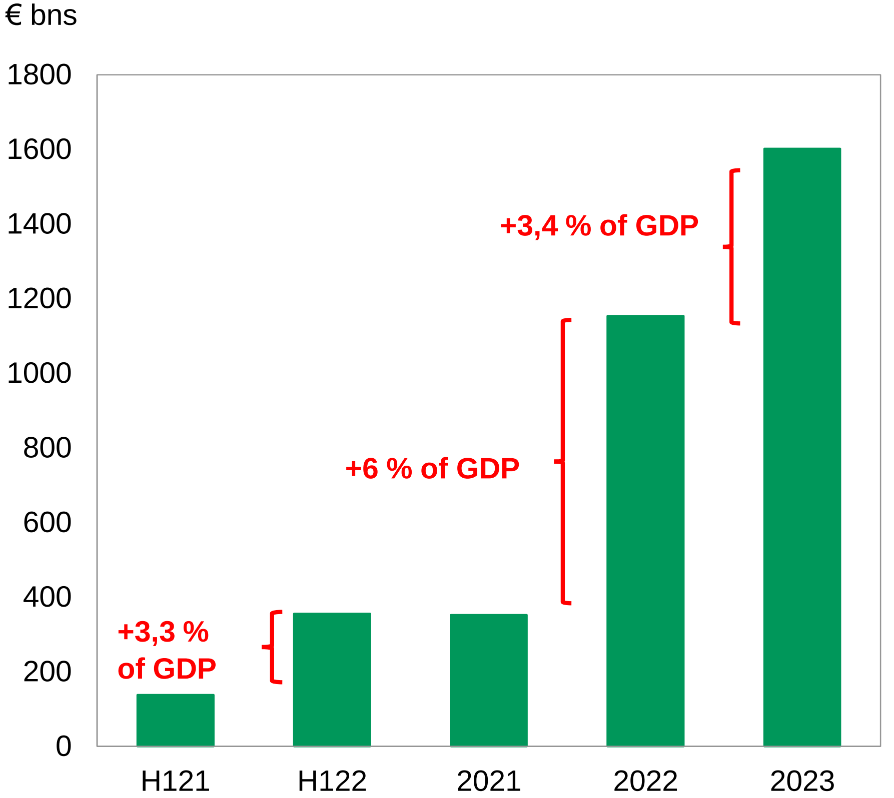
As a result of this unfortunate sequence of events, central banks are becoming increasingly concerned, not just about current inflation, but also the risks that price and wage setting mechanisms will shift and that inflation expectations will soar out of control. Their aggressive action on rates combined with higher inflation will bring the post-Covid expansion phase to a premature end.

The main concern has shifted away from the impact of inflation on household purchasing power to the risks to company profitability and to the operational challenges for businesses, which are having to contend with a more limited energy supply, rising costs and less accommodative financial conditions. **As such, we are revising our 2023 growth scenario down from 1.1% to 0.4%.**

A POWERFUL COMPETITIVE SHOCK

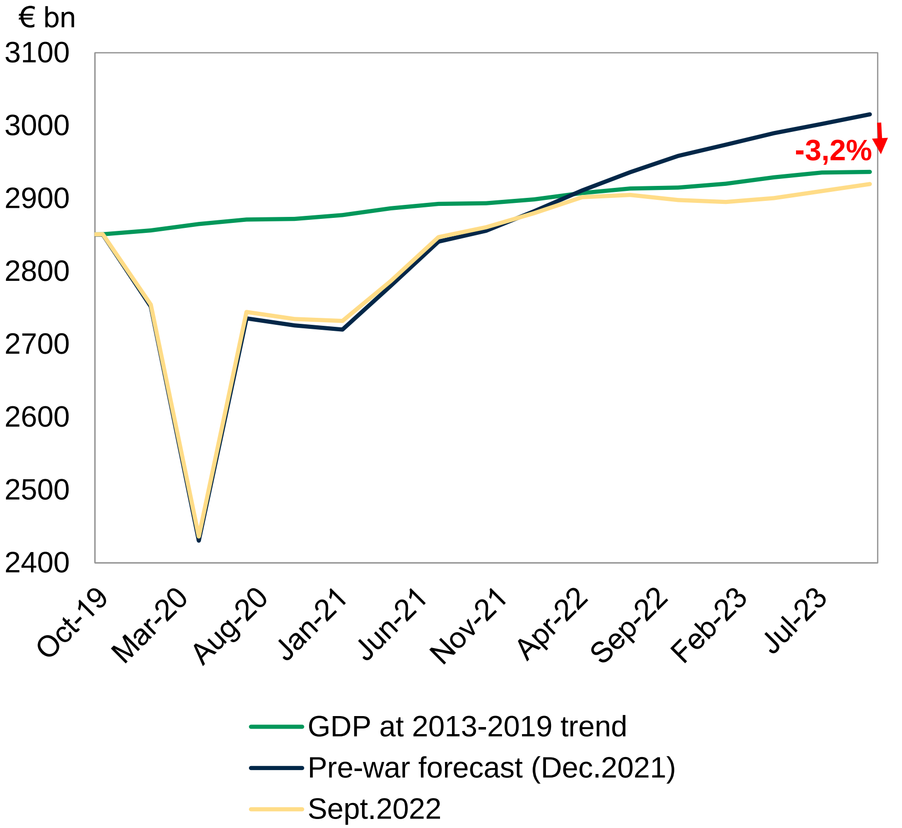
IMPACTING MEDIUM-TERM GROWTH PROSPECTS

A competitiveness shock: increase in the value of energy imports



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

A drag on medium-term growth



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

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RECENT DEVELOPMENTS AND SHORT-TERM SCENARIO

RED OCTOBER

Activity growth in the Eurozone is weakening sharply, which is reflected in September's latest surveys, particularly in the manufacturing sector where the branches that consume the most energy are already seeing declines in their business.

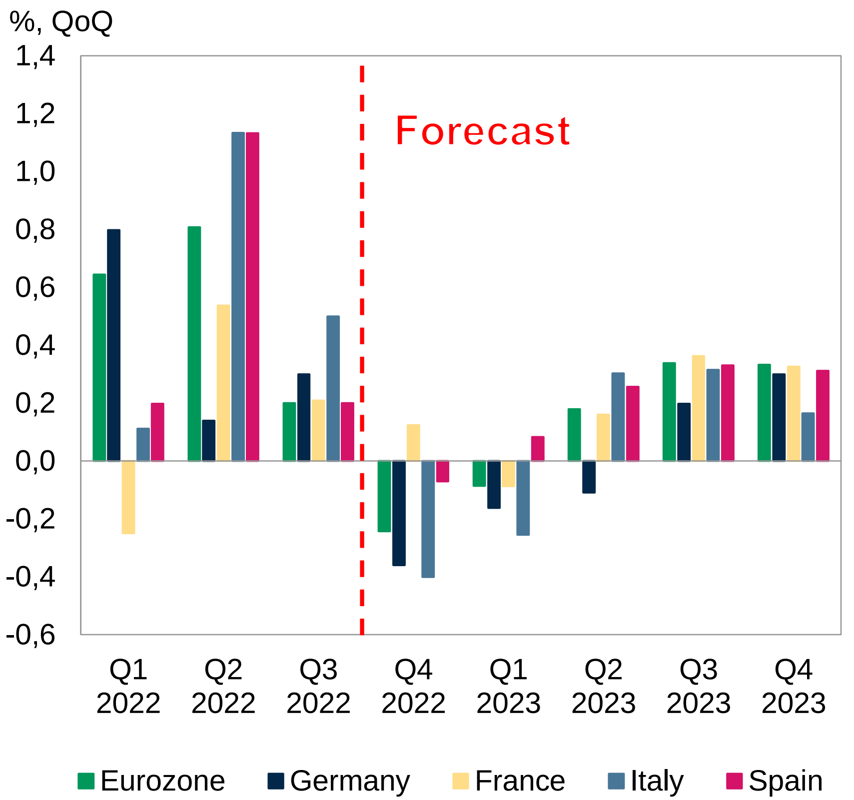
Although growth remained underpinned by the services and tourism sectors in the third quarter of 2022, **the fourth quarter is expected to see a sharp drop in GDP, one that is likely to continue in the first quarter of 2023**.

With **two quarters of moderate recession at the turn of the year**, our forecast may seem like a relatively soft landing for the Eurozone economy. However, we should not forget **that annualised GDP growth is expected to drop from 5.4% in early 2022 to 0.1% in mid-2023**.

A MODERATE RECESSION AT THE TURN OF THE YEAR

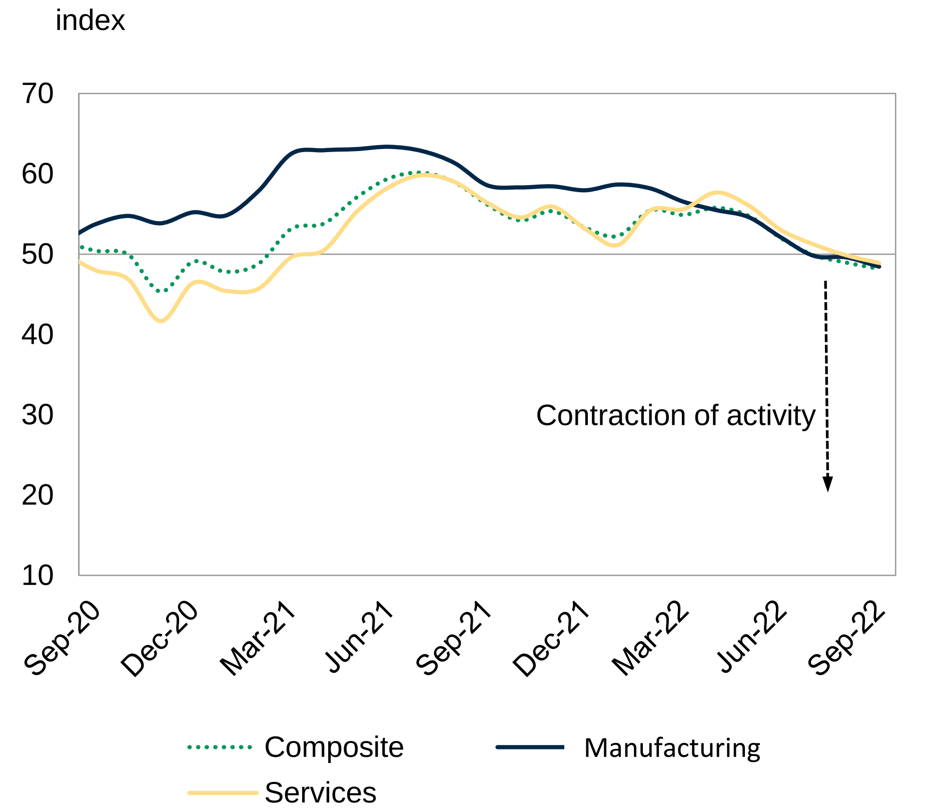
A CLEAR WEAKENING OF THE CYCLE ALREADY VISIBLE

GDP growth



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

Surveys point to a contraction in activity



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

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**	**2,0**	**2,2**	**0,5**	**0,7**	**0,8**	**0,2**	**-0,2**	**-0,1**	**0,2**	**0,3**	**0,3**	**-6,2**	**5,2**	**3,2**	**0,4**
Households consumption	-2,1	3,7	4,4	0,0	0,0	1,3	0,1	-0,4	-0,2	0,1	0,3	0,3	-7,8	3,7	3,9	0,2
Public consumption	-0,2	1,9	0,1	0,7	0,2	0,6	0,2	0,2	0,2	0,2	0,2	0,2	1,0	4,2	1,9	0,9
Total GFCF	-2,0	1,6	-0,6	3,7	-0,8	0,9	0,2	0,0	0,2	0,3	0,4	0,4	-6,6	4,1	2,8	1,1
G&S exports	0,6	2,5	2,3	2,4	1,2	1,3	1,0	0,5	0,4	0,6	0,7	0,8	-9,3	10,3	6,5	2,6
G&S imports	-1,0	3,0	2,1	4,7	-0,2	1,8	1,0	0,6	0,5	0,7	0,8	0,8	-8,8	8,0	7,2	3,0
Inventory changes (% of GDP)	0,8	0,3	0,1	0,6	0,7	0,7	0,6	0,6	0,6	0,6	0,6	0,6	0,4	0,4	0,7	0,6
Contributions to GDP growth																
Domestic demand excluding inve	-1,6	2,7	2,1	0,9	-0,2	1,0	0,1	-0,2	0,0	0,2	0,3	0,3	-5,4	3,8	3,0	0,5
Inventories	0,7	-0,6	-0,2	0,5	0,1	0,0	0,0	0,0	0,0	0,0	0,0	0,0	-0,3	0,1	0,3	-0,1
Net exports	0,8	-0,1	0,2	-0,9	0,7	-0,2	0,0	-0,1	0,0	0,0	0,0	0,0	-0,5	1,4	0,0	-0,1
Unemployment	8,2	8,1	7,5	7,1	6,8	6,7	7,2	7,4	7,4	7,3	7,4	7,5	8,0	7,7	7,0	7,4
Consumer prices	1,1	1,8	2,8	4,6	6,1	8,0	9,2	9,6	8,5	7,4	6,2	4,7	0,3	2,6	8,3	6,7
Unemployment	8,2	8,1	7,5	7,1	6,8	6,7	7,2	7,4	7,4	7,3	7,4	7,5	8,0	7,7	7,0	7,4

	Taux trimestriel (t/t, %)												Taux annuel (a/a, %)			
	2021				**2022**				**2023**				**2020**	**2021**	**2022**	**2023**
	T1	**T2**	**T3**	**T4**	**T1**	**T2**	**T3**	**T4**	**T1**	**T2**	**T3**	**T4**				
Zone euro	**-0,1**	**2,0**	**2,2**	**0,5**	**0,67**	**0,8**	**0,2**	**-0,2**	**-0,1**	**0,2**	**0,3**	**0,3**	**-6,2**	**5,2**	**3,2**	**0,4**
Allemagne	-1,5	1,9	0,8	0,0	0,8	0,1	0,3	-0,4	-0,2	-0,1	0,2	0,3	-4,1	2,6	1,6	-0,4
France	0,0	1,0	3,4	0,5	-0,2	0,5	0,2	0,1	-0,1	0,2	0,4	0,3	-7,9	6,8	2,6	0,6
Italie	0,2	2,6	2,7	0,7	0,1	1,1	0,5	-0,4	-0,3	0,3	0,3	0,2	-9,1	6,6	3,4	0,2
Espagne	-0,5	1,1	2,6	2,2	0,2	1,1	0,2	-0,1	0,1	0,3	0,3	0,3	-10,8	5,1	4,5	0,9
Pays-Bas	0,1	3,8	1,5	0,7	0,5	2,6	0,3	-0,4	-0,1	0,4	0,4	0,3	-3,9	4,9	4,7	0,9
Belgique	1,3	1,7	2,1	0,4	0,5	0,3	0,2	-0,4	-0,1	0,2	0,3	0,3	-5,7	6,2	2,5	0,1
Irlande	9,0	1,9	4,4	-1,9	6,2	1,8	0,6	-1,0	0,4	0,8	1,3	1,3	5,6	13,4	9,0	2,0
Portugal	-2,9	4,4	2,7	1,7	2,5	0,0	0,3	0,2	0,2	0,4	0,7	0,5	-8,4	4,9	6,5	1,2
Grèce	3,2	1,5	2,4	0,9	2,9	1,2	0,0	0,1	0,3	0,2	0,2	0,6	-8,7	8,0	6,2	1,1
Finlande	-0,2	1,6	0,9	0,7	0,5	0,9	0,3	-0,8	-0,5	0,3	0,4	0,4	-2,2	3,0	2,5	-0,3
Luxembourg	2,1	0,8	0,9	1,0	1,2	0,5	1,1	0,4	0,4	0,3	0,3	0,3	-1,8	6,9	3,8	1,9
Autriche	-0,8	4,4	3,7	-0,9	1,9	1,5	-0,2	-0,3	0,3	0,3	0,3	0,3	-6,9	4,8	5,1	0,9
Slovénie	1,6	2,0	1,3	5,2	0,7	0,9	0,1	-0,1	-0,1	0,2	0,2	0,2	-4,8	8,1	6,5	0,4
Malte	4,4	0,0	3,7	3,1	1,0	0,8	0,3	-0,2	-0,2	0,4	0,4	0,4	-8,2	10,2	6,0	0,7

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THE NATURE OF INFLATION

RECESSION: A RELIABLE DISINFLATIONARY AGENT

Since its return during the post-pandemic reopening of the economy, global inflation has been fuelled by two forces: excess demand and insufficient supply.

Excess demand is particularly visible in US inflation, where the massive stimulus plan aimed at supporting consumption has generated very strong spending on goods. This concentrated on the North American continent the still-low global supply, constrained by health measures in Asia. **The diversion of global freight flows to the United States and traffic jams in American ports have deprived Europe of the availability of intermediate goods from Asia and increased transport costs.**

Despite domestic demand still below its pre-Covid level in Q2 2022, the Eurozone experienced a surge in inflation. This inflation was perceived as temporary to fade with the normalisation of supply. Especially since, in the Eurozone, the labour market did not present, unlike in the United States, the conditions for the start of a price-wage spiral making inflation more permanent. The participation rate had returned to its pre-crisis level and labour demand supported by the reopening of the economy was gaining equally dynamic labour supply. Tensions were present in some sectors but remained localised there.

The reduction in Russian gas supply since autumn 2021 and the Russian invasion of Ukraine have changed the game. A new, more lasting supply shock has been grafted onto the initial imbalance. The contribution of rising energy prices to Eurozone inflation is 40%. That of food goods 23%. The spread to other goods and services is ongoing. Now more than 60% of the components of the consumer price index are in excess of a 3% inflation rate. Faced with this more persistent inflation, the ECB adopted a more aggressive strategy. Given that it cannot impact imported energy inflation, it can at least compress demand-driven inflation. On inflation of 5.6% for non-energy industrial goods, 1.7 points would be explained by demand, the rest by the supply shock. The objective is therefore to reduce the first one, even if growth is sacrificed.

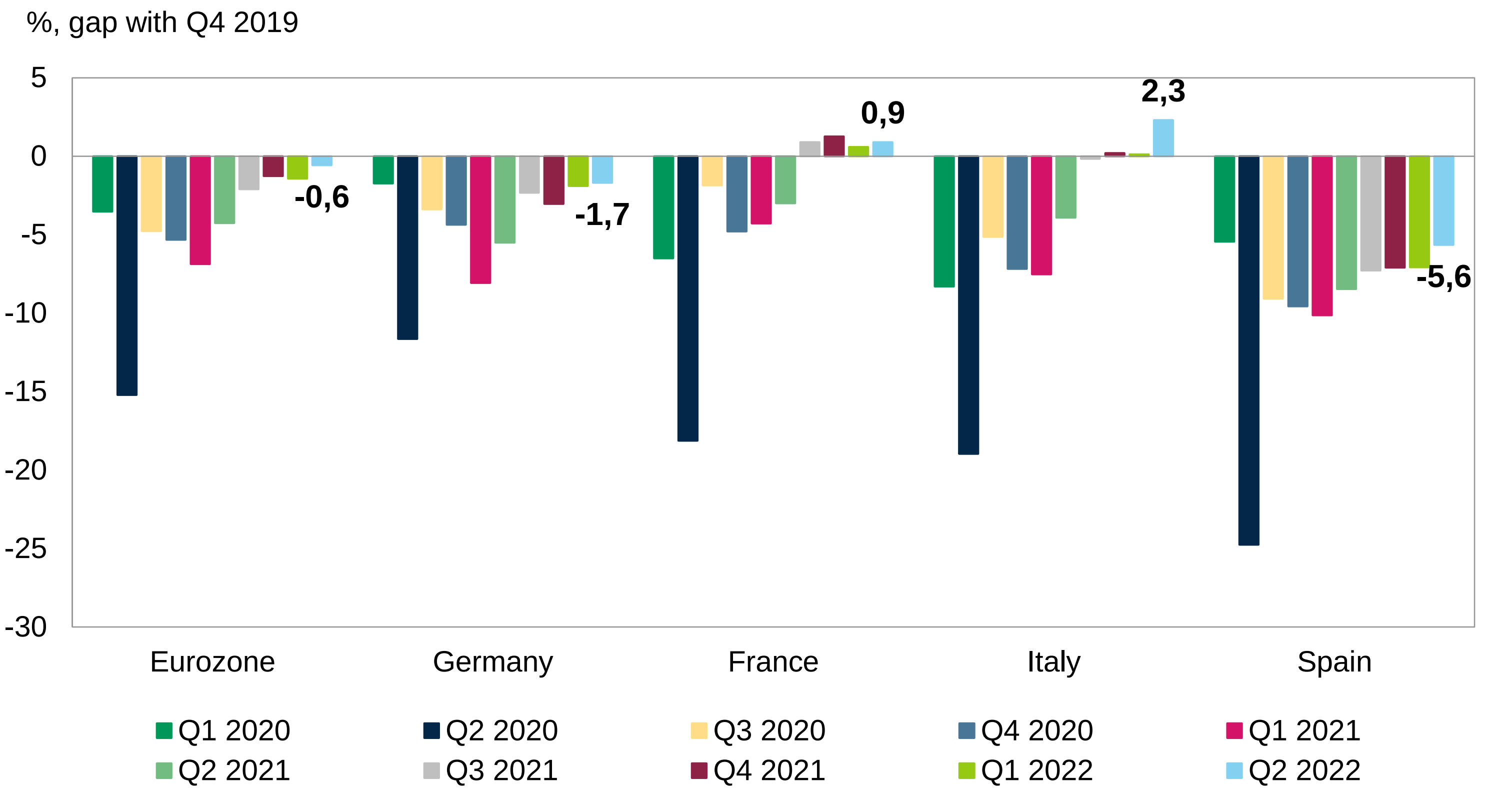
The weakening of domestic and foreign demand, and the consequence of less solicitation in supply, already makes it possible to ease constraints on value chains: the **delivery times of Eurozone industry have already been shortened and freight prices have been reduced**.

In the short term, the effect of the spread of energy inflation to other components of the price index will dominate, but at the beginning of 2023, the effect of weakening demand will take precedence. Also despite a still-high gas price on average over 2023 (€225/MWh), its contribution to inflation will be lower than in 2022. It is on the preponderance of these two latter effects **that our scenario assumes a drop in inflation in 2023 (to 6.7%, after 8.3% in 2022).**

LOW DEMAND-DRIVEN INFLATION

NO EXCESS DEMAND

Domestic demand: gap with the pre-crisis level

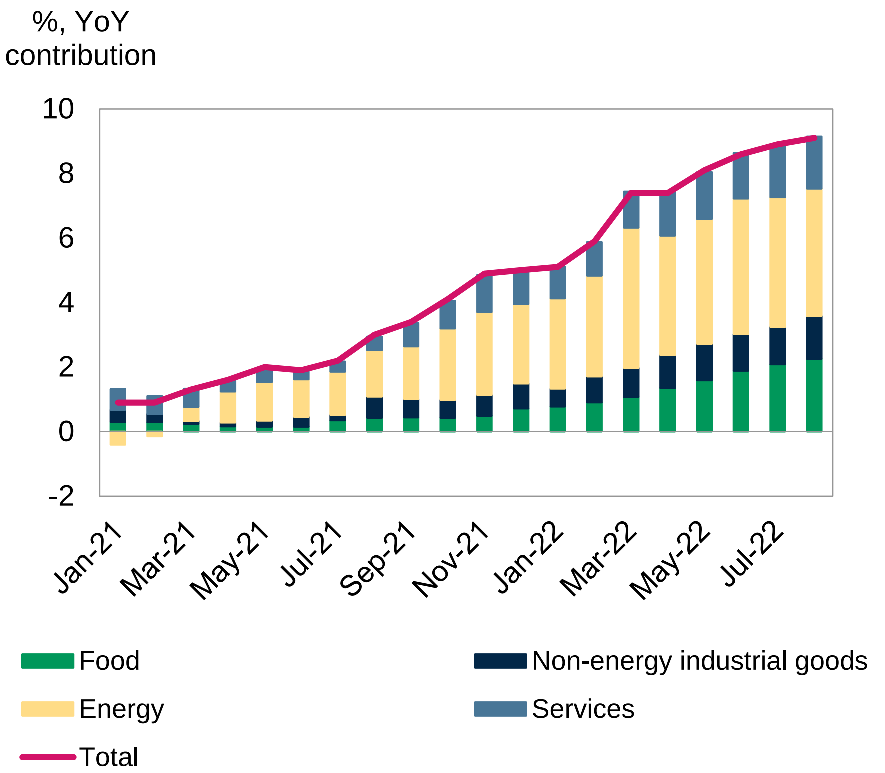


Sources: Eurostat, Crédit Agricole S.A.

A SUPPLY SHOCK THAT DOMINATES PRICE PRESSURES

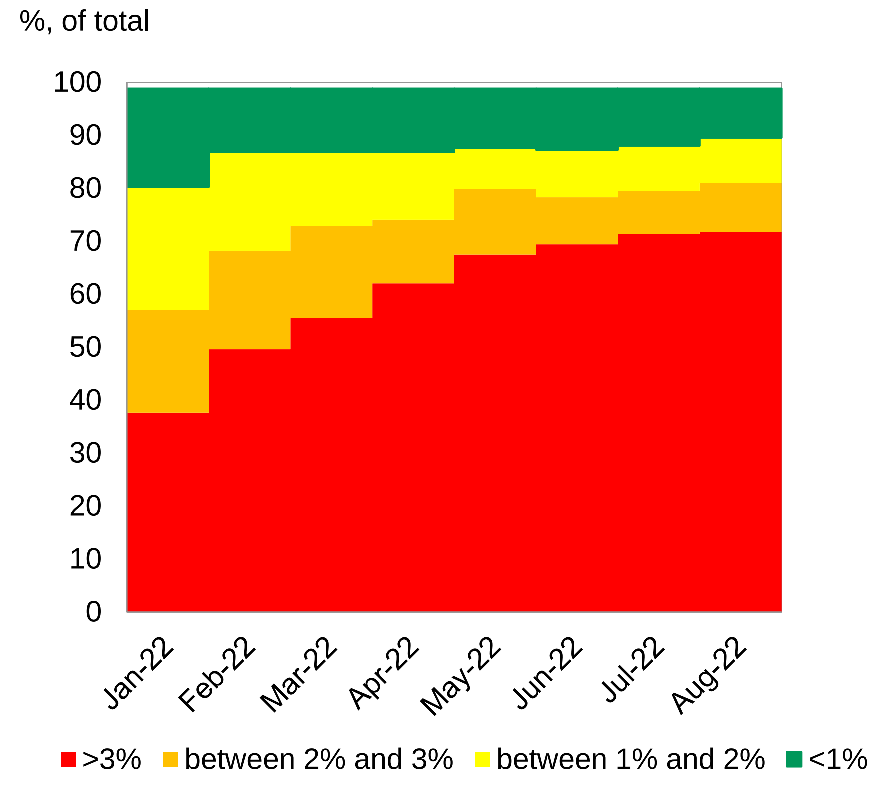
BUT IS SPREADING MORE AND MORE

Contributions to inflation: energy and food dominate



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

Dissemination of price increases: inflation by price index component

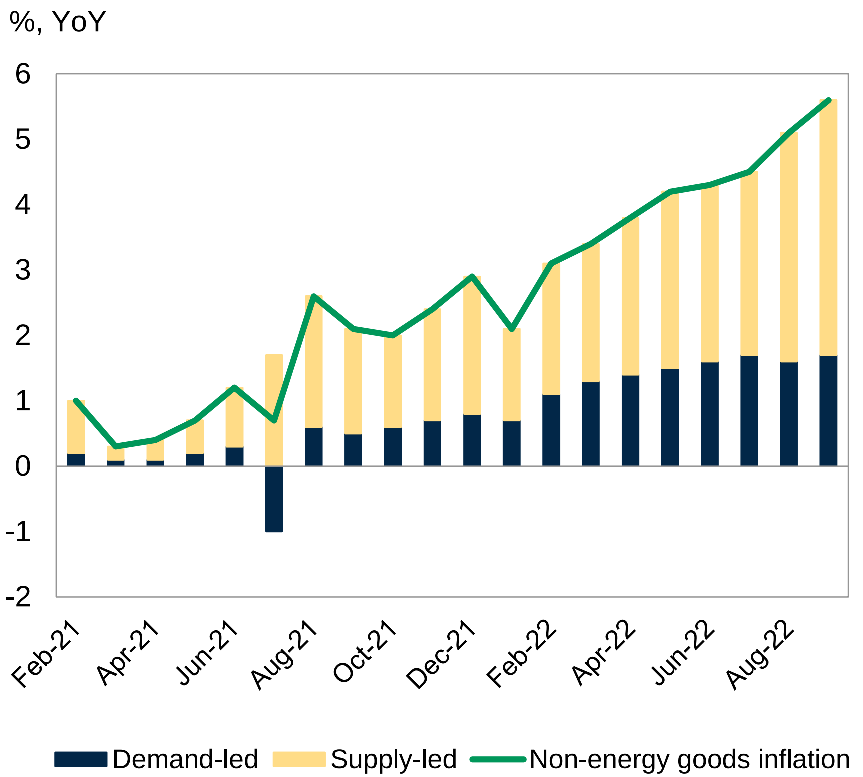


Sources: Eurostat, Crédit Agricole S.A./ECO

RECESSION: A POWERFUL DISINFLATIONARY AGENT

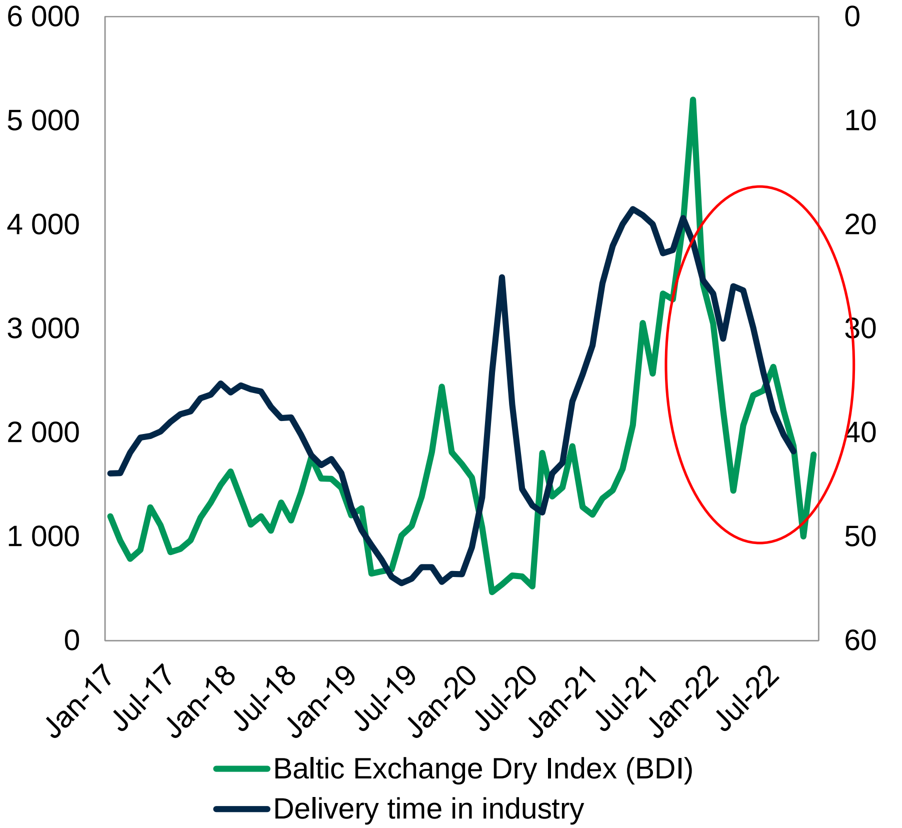
DEMAND-DRIVEN INFLATION COULD EASE

Breakdown of the inflation shock: mainly a supply shock



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

Less demand, less tension on supplies



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

THE NATURE OF INFLATION
TWO IMPORTANT CIRCUIT BREAKERS

A prerequisite for inflation to remain transitory, although more persistent than initially anticipated, is to avoid the start of the price-wage spiral.

Wages resulting from the negotiations in the Eurozone showed some signs of acceleration but still point to contained dynamics, mainly affected by increases in the minimum wage. The negotiated wage index rose at a rate of 2.4% in Q2 2022 in the Eurozone and Spain and at a rate of 1% in Italy. In Germany, for which we already have Q3 2022, growth is 2% (1.4% excluding premiums). The expected slowdown in activity should bring employment preservation considerations back to the top of the agenda, especially for the sectors most affected by the energy crisis. Negotiations may aim to make up for the past loss of purchasing power, which can also involve increases in premiums or aim to compensate for higher expected inflation over the long term and thus trigger a wage-price spiral.

It is therefore essential to prevent expectations from anchoring on very high inflation over the long term. The main objective of the ECB is to avoid this de-anchoring by a more aggressive monetary policy sending the signal of intolerance to the slippage of inflation.

While the effective salary has remained on a stronger trend than the negotiated salary, it is mainly due to the effect of bonuses aimed at catching up with the low growth of the Covid years and the effect of the increase in hours worked. As the process of normalising hours worked has been completed, this wage drift should decrease and bring the increase in the actual wage more in line with the negotiations.

Another important circuit breaker is the decoupling of electricity prices from gas prices. In the European Union, the price of electricity is set on the marginal cost of the last production that met the order of call to meet demand.

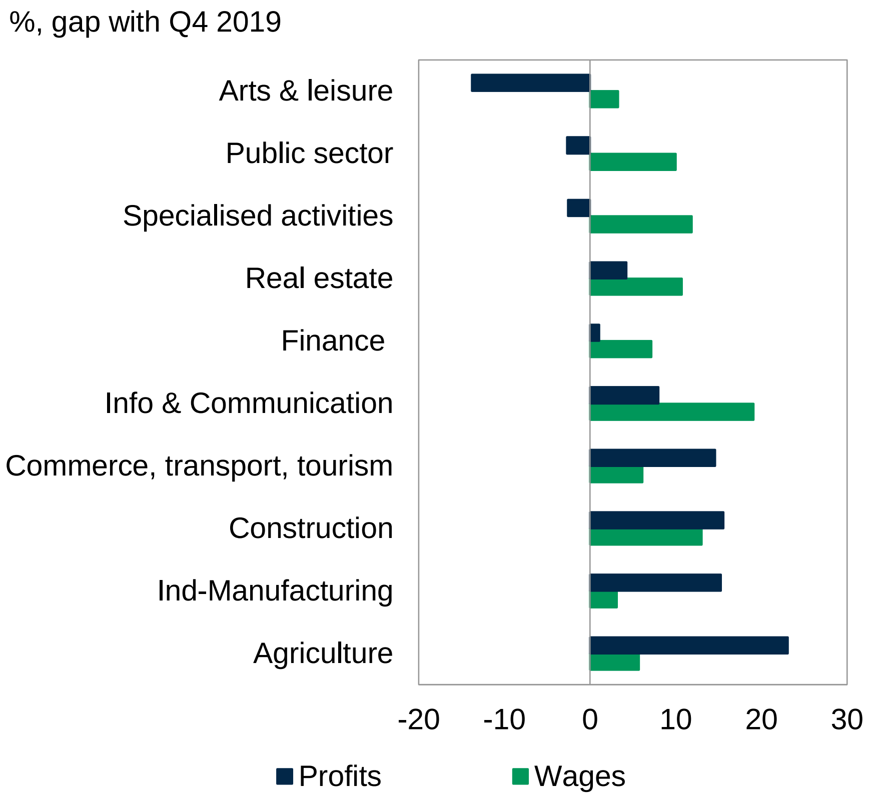
After responding to the demand with cheaper (renewable) production, the most expensive productions, including gas, are being put into production. It is therefore the latter which currently sets the price of electricity. **This mechanism means that the rise in gas prices is now automatically transferred to the various components of the price index. Cutting this mechanism would be a considerable step forward to limit the spread of inflation and therefore its persistence.**

Our forecast is for a sustained high gas price in the medium term. It is estimated that global LNG supply will remain constrained until 2025 by limited extraction and liquefaction capacities. The global gas market will have to do without a large part of the Russian gas supply and the arrival of Europe as a major buyer in the LNG market.

SECOND-ROUND EFFECTS

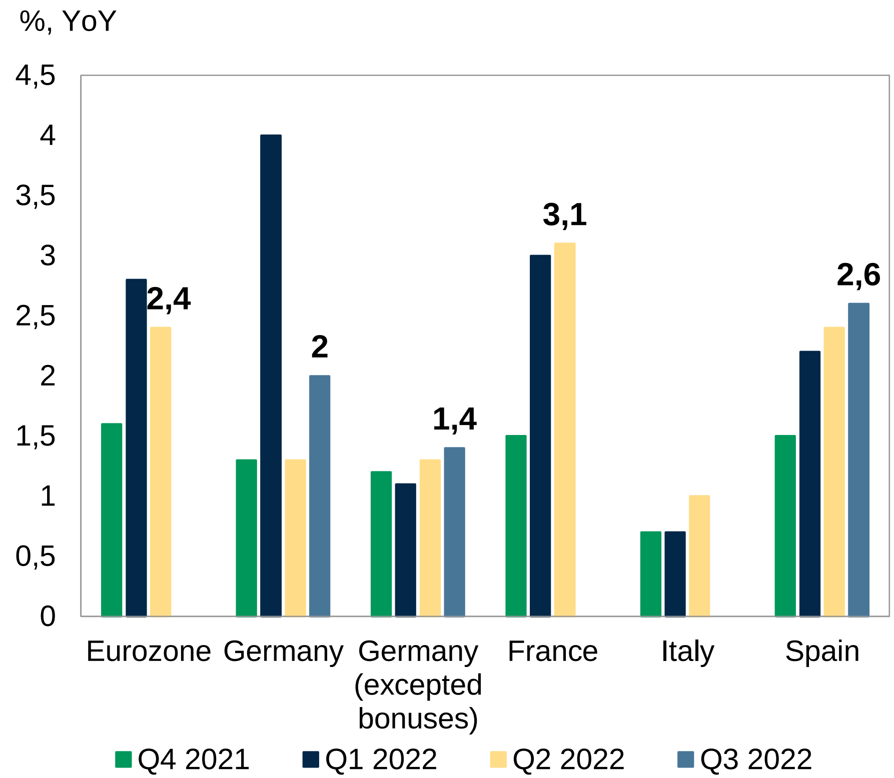
NOT VISIBLE AT THIS STAGE

Wage increases but also of profits



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

Negotiated wages: far from catching up with inflation



Sources: DARES, Destatis, ECB, Istat, Ministerio de Trabajo, Crédit Agricole S.A./ECO

ELECTRICITY PRICES UNDER PRESSURE

PAY-AS-CLEAR: ACTUAL PRODUCER COSTS AND MARKET PRICE

Production volume and call order	Marginal cost of production
100 GW	• Gas > €70
80 GW	• Coal €55
60 GW	• Nuclear €30
40 GW	• Hydro €15
30 GW	• Solar/Wind €0

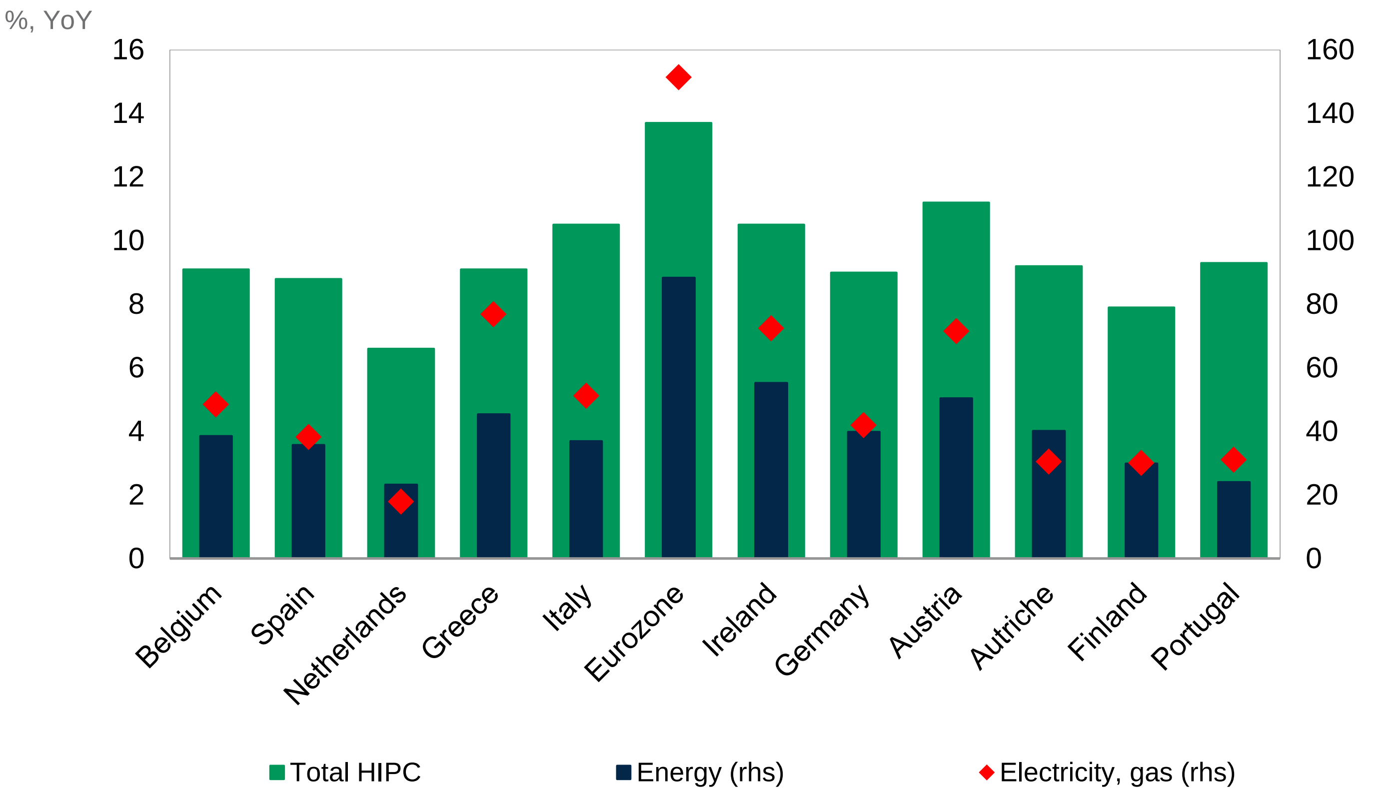
If demand
>80 GW
price = gas price

If demand
≤80 GW
price ≤ €55

ENERGY GOODS INFLATION

FROM NATURAL GAS TO ALL ENERGY

Electricity, gas and other fuels: different inflation rates



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

SHORT-TERM INFLATION CAN FALL

FOR AND AGAINST

Inflation target

Falling global demand

Unwinding of tensions on non-energy supplies

Lower contribution from higher gas prices

Energy inflation spreading to other components

MEDIUM TERM: PRESSURE ON FOSSIL FUEL PRICES PERSISTS

US and Qatar LNG supply constrained until 2025

Insufficient regasification infrastructure

Northern European gas pipeline capacity at its maximum

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THE LOGIC OF THE SCENARIO

A MODERATE RECESSION AND A SLOW DIGESTION OF THE SHOCK

We have relegated the hard landing scenario to an adverse scenario. **The Eurozone economy may still receive a boost from robust job creation, solid growth in wages and healthy balance sheets at private companies.** Labour shortages in certain sectors and the use of the short-time work scheme at businesses hardest hit by rising costs and rationing will curb the rise in the unemployment rate.

In our central scenario, efforts to diversify gas supply and the voluntary reduction of consumption should help to avoid stricter rationing. This reduction will take place via market forces, either through auctions involving consumer companies (as detailed in certain countries' emergency plans) or through "voluntary" stoppages of businesses that are not profitable enough due to rising costs.

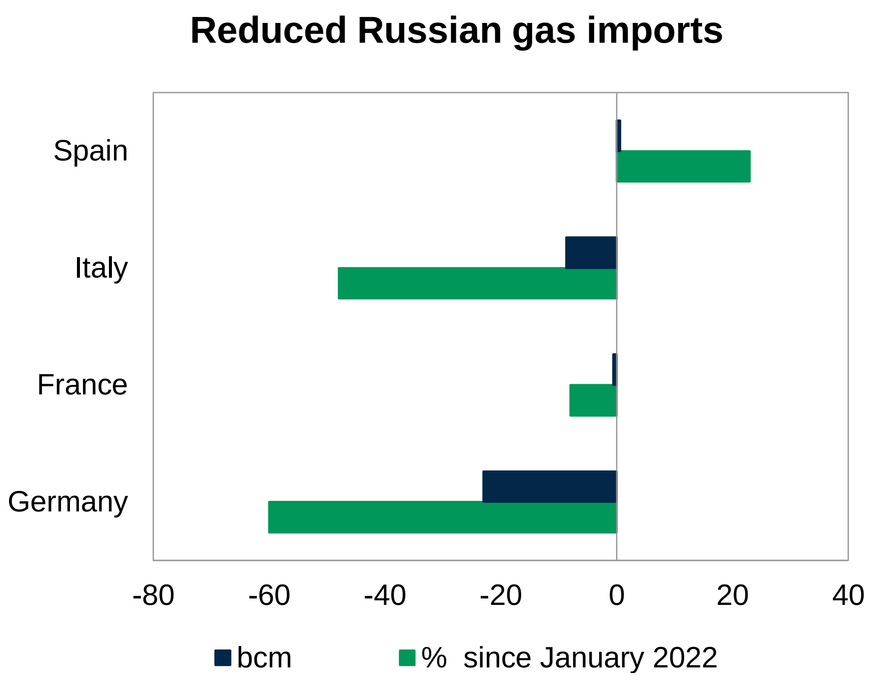
A recession scenario is certainly forming, but it remains moderate and no wishful thinking is needed for now to validate it. If businesses were to contend with serious pressure on margins combined with weakening domestic and foreign demand, lower usage of the available supply would help ease the restrictions on value chains. The recession could, and will, end up being a fairly reliable source of declining inflation.

Only part of the competitiveness shock will be felt immediately and cause growth to weaken. The remainder will be gradually absorbed and trigger a deterioration in economic agents' balance sheets and the region's external position.

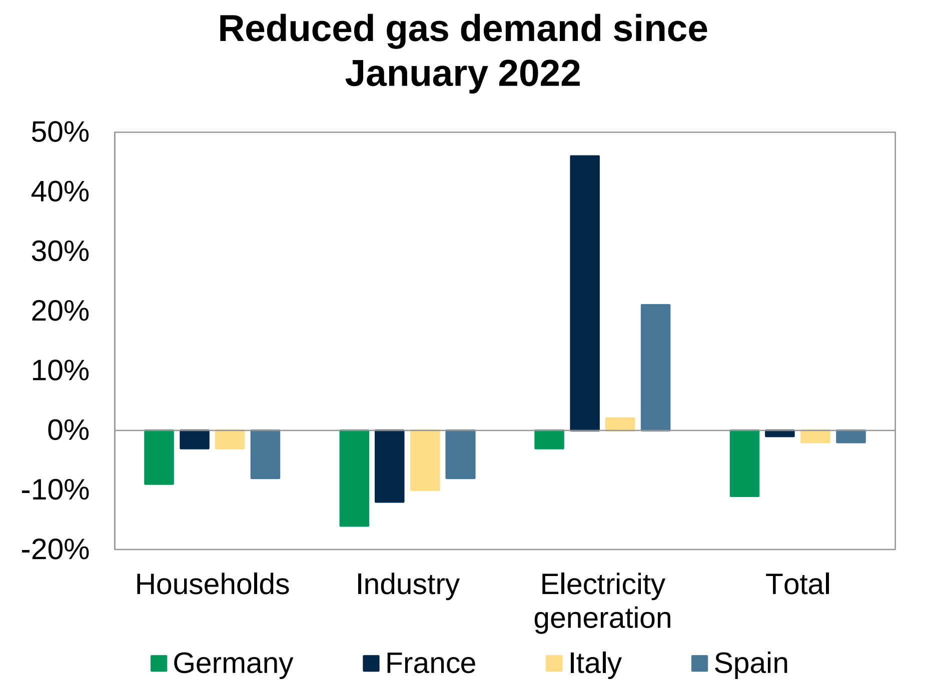
This will significantly hamper the economy's ability to quickly return to its prevailing pre-war growth trend. The impact on household consumption will be more acute in terms of spending on durable goods, as services spending will remain underpinned by more affluent households that still have substantial excess savings to draw on. Meanwhile, investment will continue to benefit from national and European energy and digital transition plans.

THE IMPOSSIBILITY OF REPLACING RUSSIAN FLOWS

THE EU'S DESIRE TO REDUCE DEMAND BY 15% THROUGH VOLUNTARY REDUCTIONS



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



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

Substitution of sources of supply: LNG imports, "limited" increase in gas deliveries from other producers (Norway, Azerbaijan, etc.). The share of Russian gas in our gas imports decreased from 40% to 9%.

Inventory status: Currently > 80% of gas reserves. By importing an additional 3 billion m^3, France could end the winter with inventories of more than 30%.

Without a new terminal, Germany would be forced to reduce its consumption by 15% to finish the winter with inventories at 35%.

Soaring prices and purchasing power shock mitigated by support measures, energy sobriety measures are sufficient, possible voluntary production shutdowns but no forced rationing.

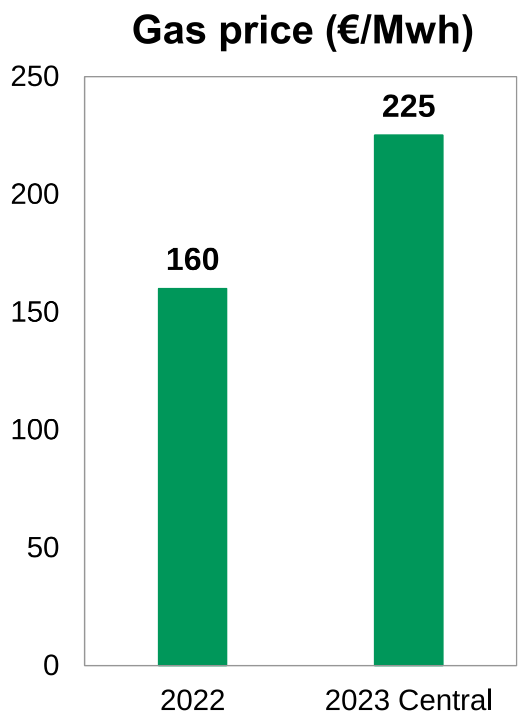
CENTRAL SCENARIO: ASSUMPTIONS

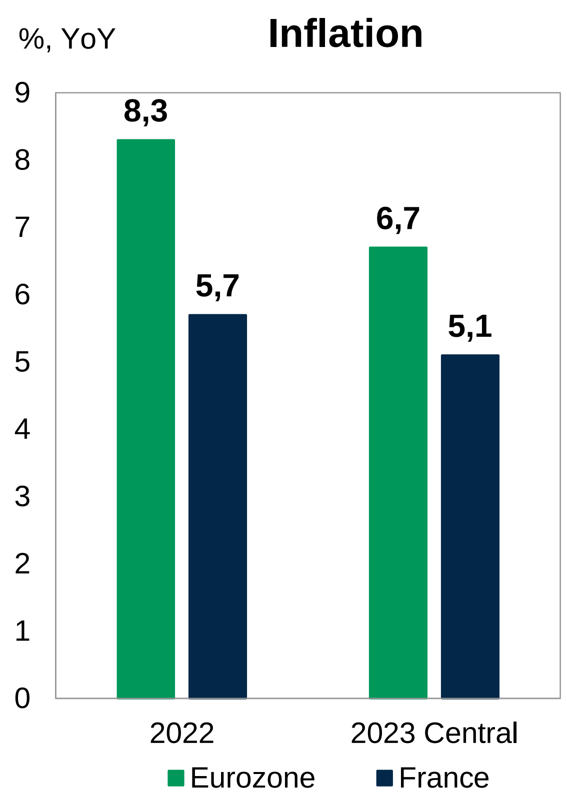
NORMAL WINTER AND FRENCH NUCLEAR PARK AT 42 GW: PURCHASING POWER SHOCK, VOLUNTARY RATIONING

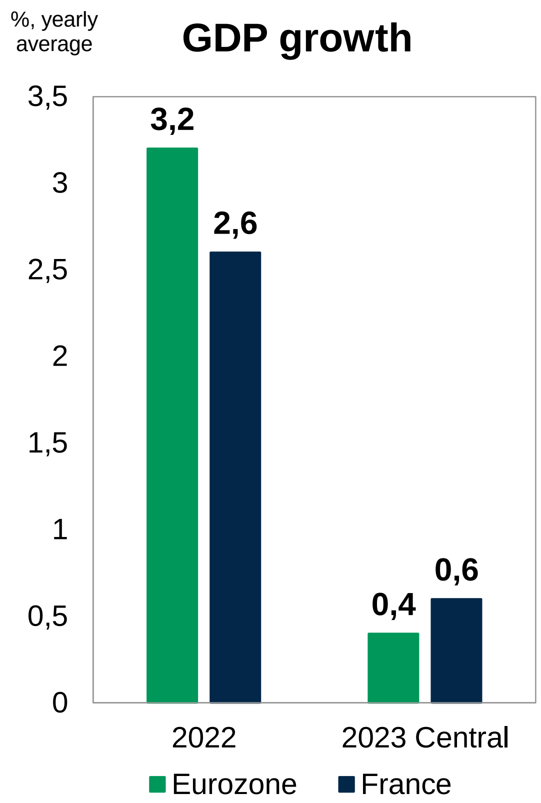
	Central scenario
Climate	Normal winter
French nuclear production capacity	42 GW
Additional LNG demand	France: +3MMC Germany: if no new terminal, 15% reduction in consumption
Inventory	>30%
Actions	Sobriety, voluntary rationing
Fiscal support	Possible, by redistributing surplus profits

GAS CRISIS: IMPACTS

CENTRAL SCENARIO





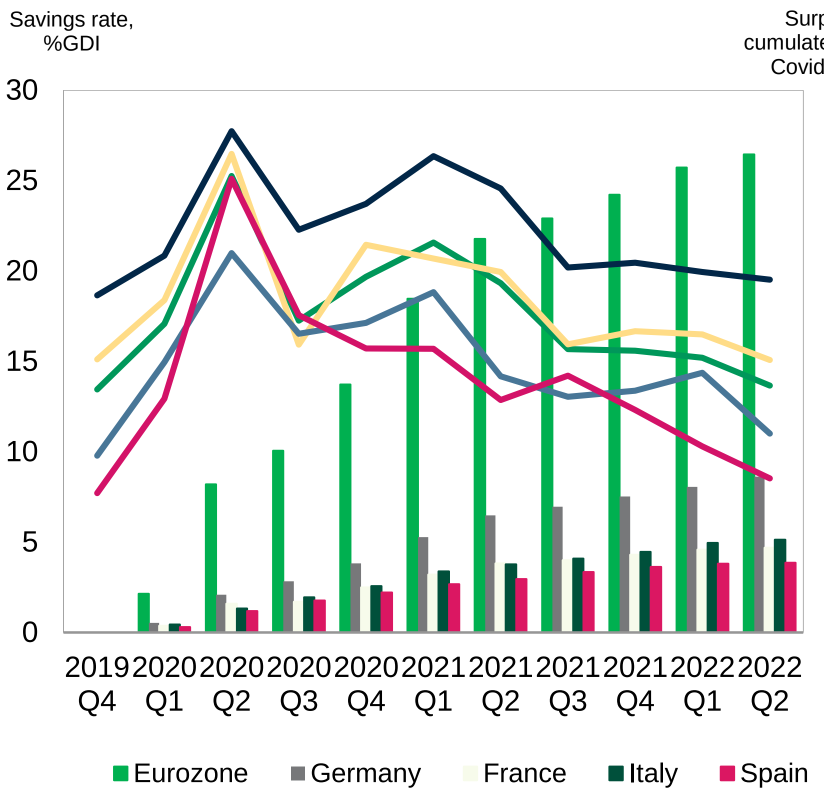


Sources: Eurostat, Crédit Agricole S.A./ECO

SUPPORTING FACTORS

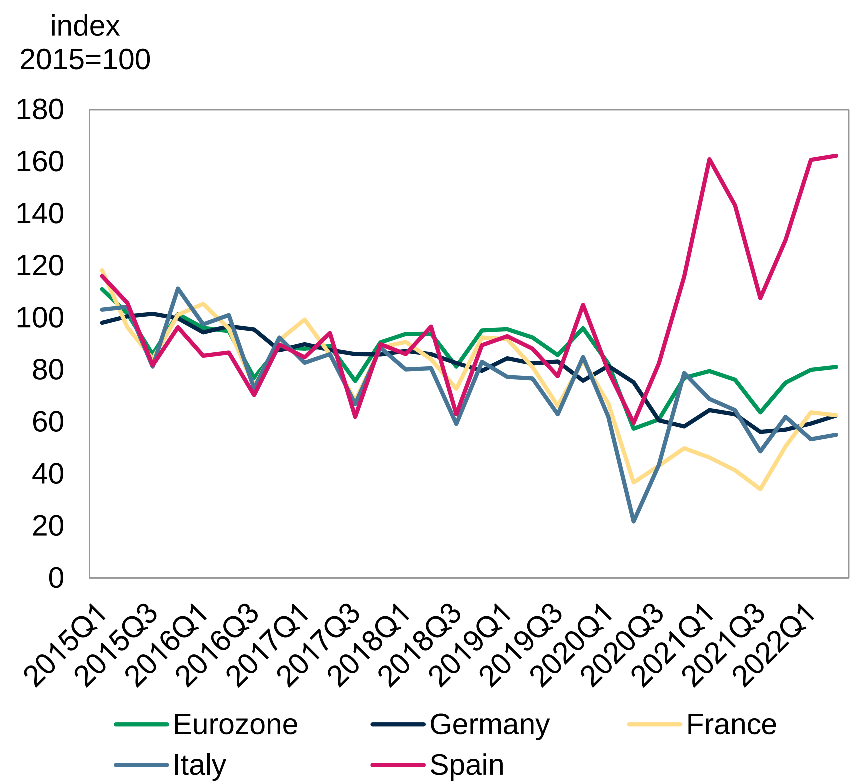
HEALTHY BALANCE SHEETS IN THE PRIVATE SECTOR

A still-large surplus of savings



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

Bankruptcies under control



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

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THE GAS STRESS SCENARIO

A DEEPER RECESSION AND RATIONING

Outlining an adverse scenario is simply a matter of tweaking our energy-related assumptions.

This scenario would combine **a complete cut-off of Russian gas supply**, which is highly likely amid insufficient and very expensive LNG supply, more lasting challenges for the French nuclear industry, and increased tensions over gas demand and prices, with repercussions on electricity prices.

If we also assume that there will be a harsh winter in 2023, European governments would inevitably have to resort to their gas rationing plans (despite reducing consumption by 15% over the winter).

If the average market price for natural gas remains within the €275-375/MWh range in 2023, inflation would remain high at 8.5% next year. Rationing would primarily impact manufacturing and reduce activity in sectors that are highly dependent on gas. As a result, investment would fall, and consumption would drop slightly on the back of a greater than expected deterioration in the labour market. **Average annual GDP would fall 0.6% in 2023 in this scenario.**

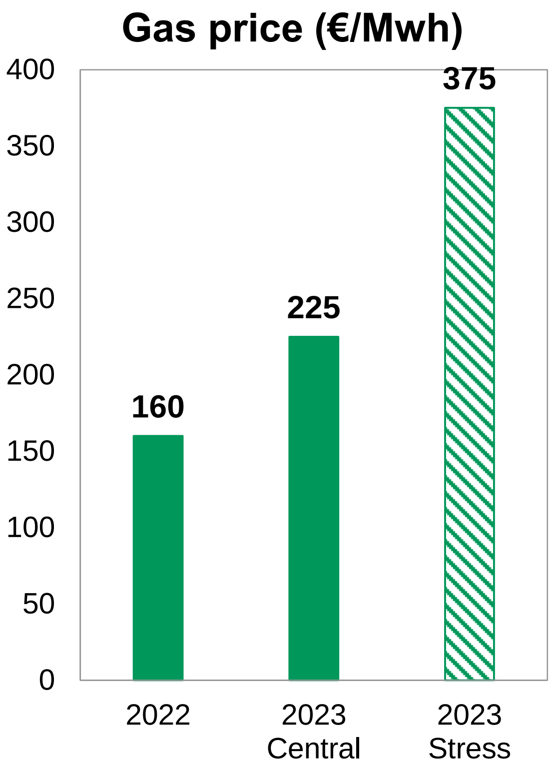
GAS STRESS SCENARIO: ASSUMPTIONS

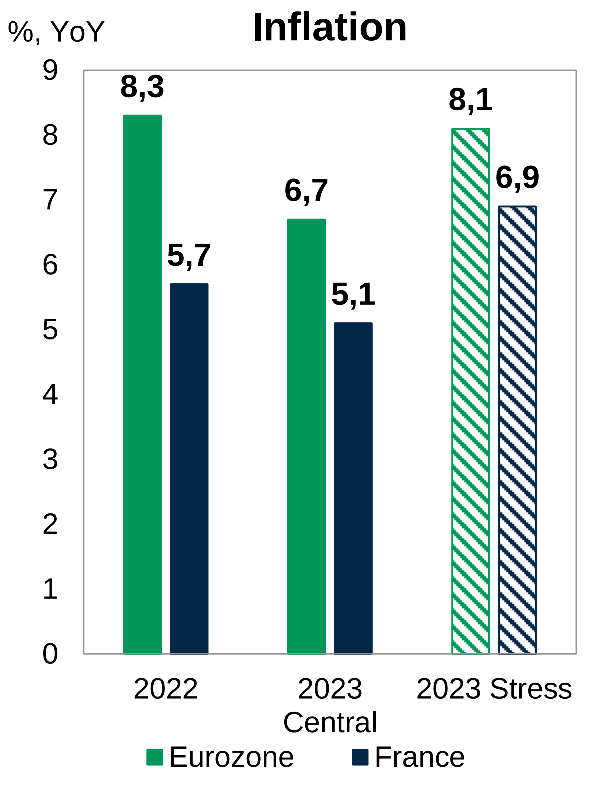
SHUTDOWN OF RUSSIAN FLOWS, ROUGH WINTER AND FRENCH NUCLEAR PARK AT 30 GW: FORCED RATIONING

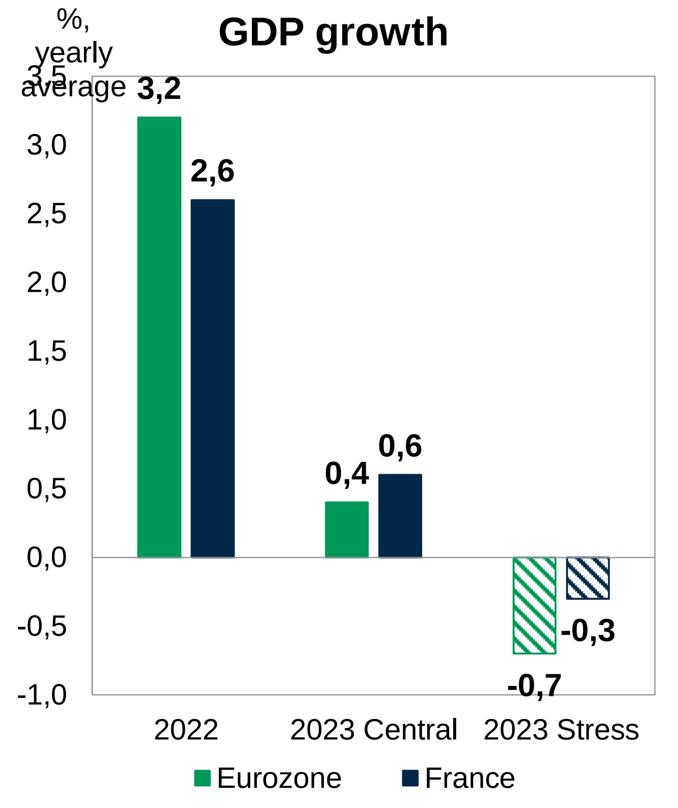
	Stress scenario: total shutdown of Russian gas
Climate	Harsh winter
French nuclear production capacity	30 GW
Additional LNG demand	+22.5MMC
Inventory	0% if 15% reduction in consumption >30% if 30% reduction in consumption
Actions	Forced rationing for sectors consuming more
Fiscal support	Too expensive

GAS CRISIS: IMPACTS

CENTRAL AND STRESSED SCENARIO







Source : Crédit Agricole S.A.

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POLICY MIX

THE END OF DIVINE COINCIDENCE

Governments will be tasked with organising the response to this competitiveness shock, ensuring that the situation at certain stakeholders does not deteriorate excessively and doesn't exacerbate the initial shock. This task will be all the more challenging since the divine coincidence of fiscal and monetary policy sharing the same goal of stabilising activity and prices is now over.

The European Central Bank is now directly targeting weaker activity in order to cool inflationary tension on services and non-energy goods. **It also aims to keep inflation expectations anchored to its target.** While these have widened in the short term, 5-year market expectations remain slightly above the 2% target. They widened between May and June 2022, when the assumption of a long war and the definitive abandonment of Russian gas by European countries became a certainty, and thus lastingly higher prices. However, the ECB's more determined-than-expected action in its decision to raise interest rates in July brought expectations back to the target. **Faced with prices having a structurally weaker reaction to the decline in activity, there is a risk that the sacrifice in terms of growth may be greater than in the past.**

Regulatory policy could help to effectively complement the policy mix and make the ECB's dilemma less acute, while limiting the budget policy support effort required. The European level of economic policy has an increasingly important role to play. Solidarity between countries is more vital than ever. Supply capacity will have to be shared (otherwise rationing will become unavoidable). Costs will have to be shared too, and income generated from the shortages will have to be redistributed.

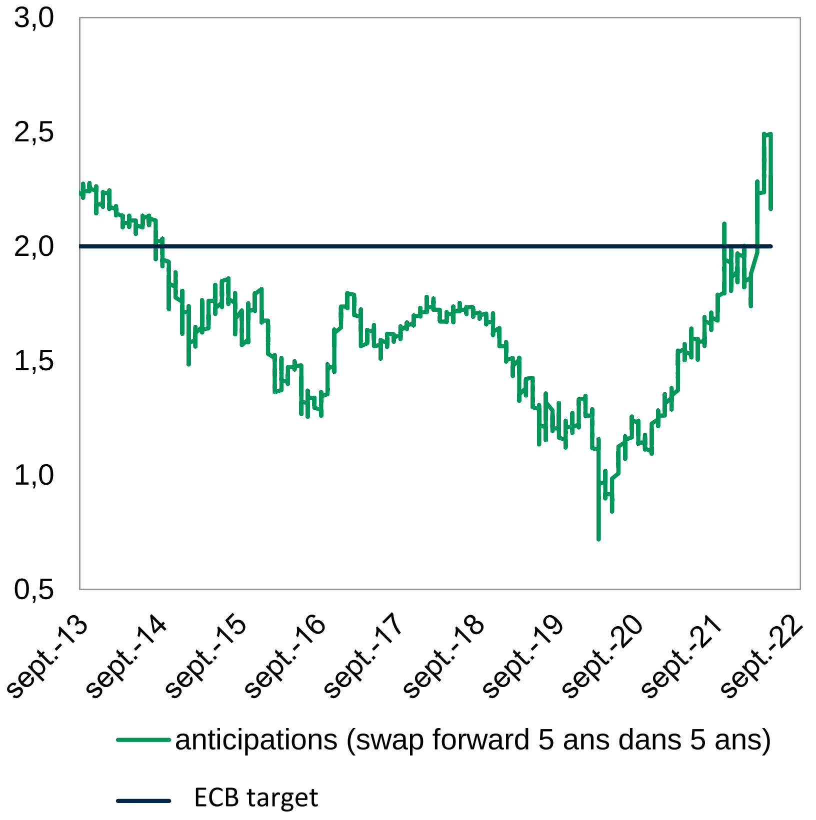
The European Council on 20 October approved the Commission's proposal for the joint purchase of gas on a voluntary basis. In addition, a new FTT benchmark should be launched by the beginning of 2023 and, in the short term, a temporary dynamic price corridor for natural gas transactions should immediately limit excessive gas price episodes. **Finally, the Commission has been mandated to present a temporary framework to cap the price of gas used in electricity generation. These measures should contain the rise in gas prices and, above all, its spread to all prices, but they will take too late to avoid the next rate hikes expected in December (50bp) and in February (25bp).**

Fiscal policy has found some relief in the European decision to have energy producers (excluding oil and gas) contribute and in imposing a tax on the super-profits of oil and gas producers. Revenues collected when electricity prices exceed €180/MWh would amount to around €117bn, and tax revenues would be €25bn.

THE ECB IS INCREASINGLY DETERMINED

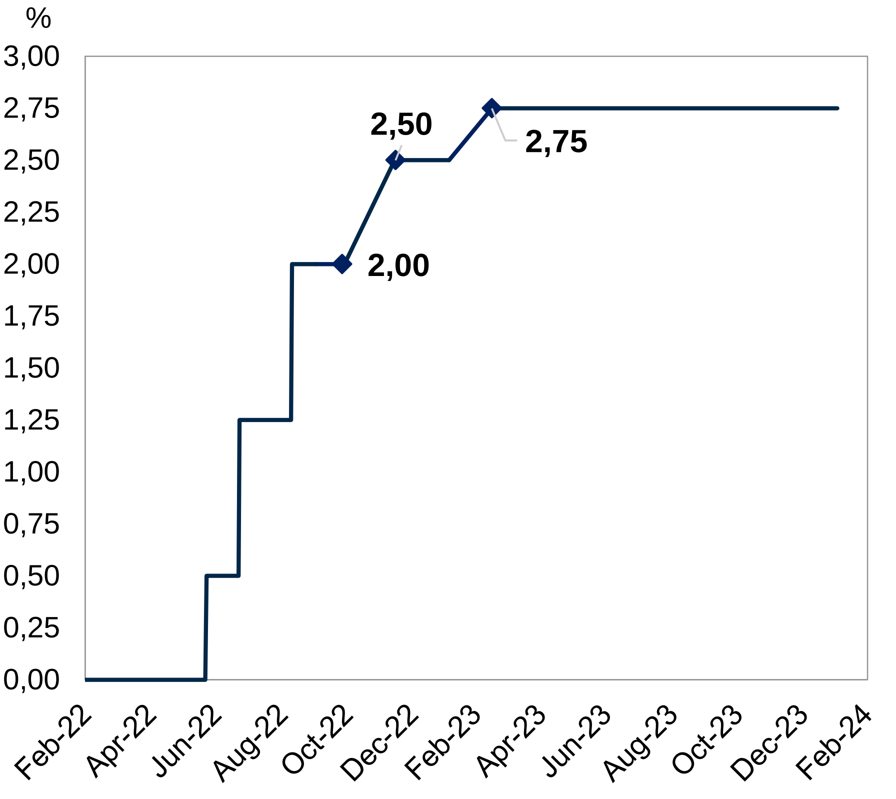
CURBING DEMAND AND ANCHORING EXPECTATIONS

Inflation expectations: aggressive tightening and slowing activity anchor expectations



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

Key rate: two more hikes



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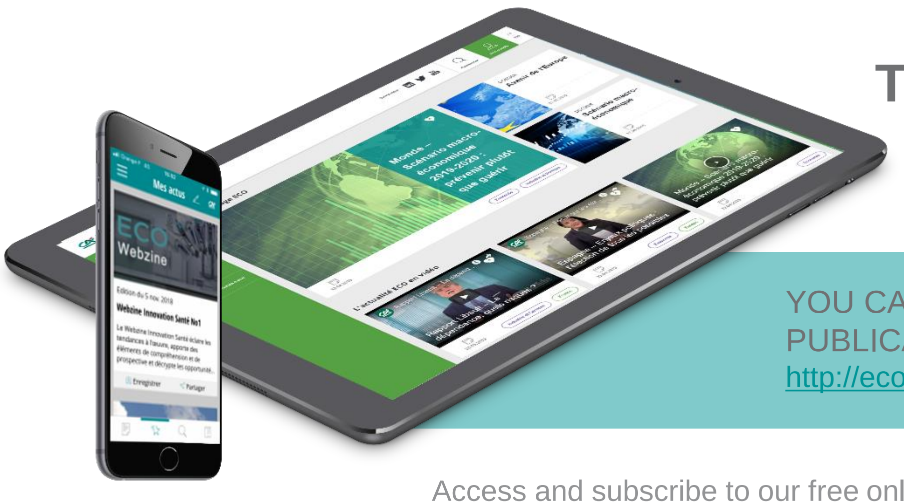

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