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PICTET WEALTH MANAGEMENT

Euro area 2023 macro outlook

Inflation will remain in focus

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FLASH NOTE

SUMMARY

- The euro area economy has been surprisingly resilient since the start of the war in Ukraine in February. This can be partially attributed to the post-pandemic rebound in some service industries, as well as government measures to shield consumers and companies from high energy costs. The good health of the labour market has also been a key support. Recent data point to a moderate recession in the euro area stretching from Q4 22 to Q1 23. We expect euro area GDP to contract by 0.2% in 2023, down from growth of 3.3% in 2022.
- We expect headline inflation to fall moderately in 2023, mainly driven by energy. While the easing of supply bottlenecks should also help to slow inflation, rising wages and the indirect effects of the energy shock should ensure price pressures remain elevated. We see headline inflation in the euro area averaging 5.3% in 2023, down from 8.5% in 2022 and core inflation averaging 3.5% in 2023 after 3.9% this year.
- We have adjusted our rates expectations to take account of the hawkish message delivered by the European Central Bank (ECB) at its December meeting. We now see the ECB hiking the deposit rate by 50bp first in February, 50bp again in March and May, before it marks a pause. This will bring the deposit rate up to 3.5% by the end of May 2023.

A MILD RECESSION

The euro area economy grew at strong pace in the first half of 2022 but slowed considerably in Q3. Recent data point to a moderate recession in the euro area stretching from Q4 22 to Q1 23. Larger-than-expected levels of gas storage have reduced the risk of energy rationing (barring an extremely cold winter or disruptions to existing flows). The services sector has continued to benefit from post-pandemic demand, but the hit to households' disposable income from high energy prices will push consumer spending down again.

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We expect only a modest economic rebound in H2 2023 as government emergency energy support measures are progressively removed and the lagged effects of tighter financial conditions begin to bite. In addition, the energy situation remains fragile and even if gas prices have eased since their August peak, they are likely to remain higher than they were before Russia's invasion of Ukraine. Should the energy situation deteriorate, governments could step in again.

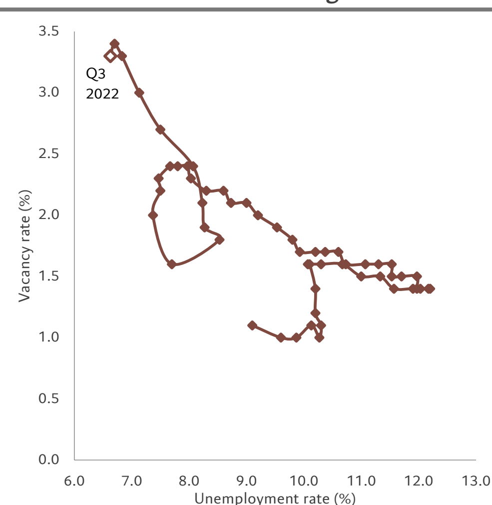
On the positive side, NextGenerationEU, the EU's recovery fund, will continue to support growth, particularly in peripheral countries. The continued resilience of the labour market (see *chart 2*) and the pick-up in wages (see *chart 1*) will also be a key support for household consumption and help mitigate the negative effect of the energy shock. In addition, the easing of supply-chain constraints should help European manufacturers regain some momentum.

In all, we forecast euro area growth of -0.2% in 2023, down from 3.3% in 2022. Risks to our growth forecasts remain tilted to the upside. Country wise, Germany and Italy will be more affected by energy issues than France and Spain, which have more diversified sources of energy supply and are both relatively more services-oriented economies.

Chart 1: euro area negotiated wages

Source: PWM, ECB, 21 December 2022

Chart 2: euro area Beveridge curve



Source: PWM, Eurostat, 21 December 2022

SOFTER BUT STILL ELEVATED INFLATION

Inflation will once again be a key focus in 2023. The post pandemic rebound and the energy shock brought euro area headline inflation to a historical high of 10.6% year over year (y-o-y) in October. Inflation eased somewhat in November but remained elevated at 10.1% y-o-y. We expect headline inflation to fall moderately in 2023, mainly driven by energy. In 2022, increases in energy prices, particularly for gas, have kept headline inflation very high. With the correction in commodity prices, base effects that have been pushing up annual inflation figures should gradually wear off.

Having said that, while inflation may have peaked in Q4, it remains an issue, with uncertainty and volatility in headline prints to be expected in the coming months.

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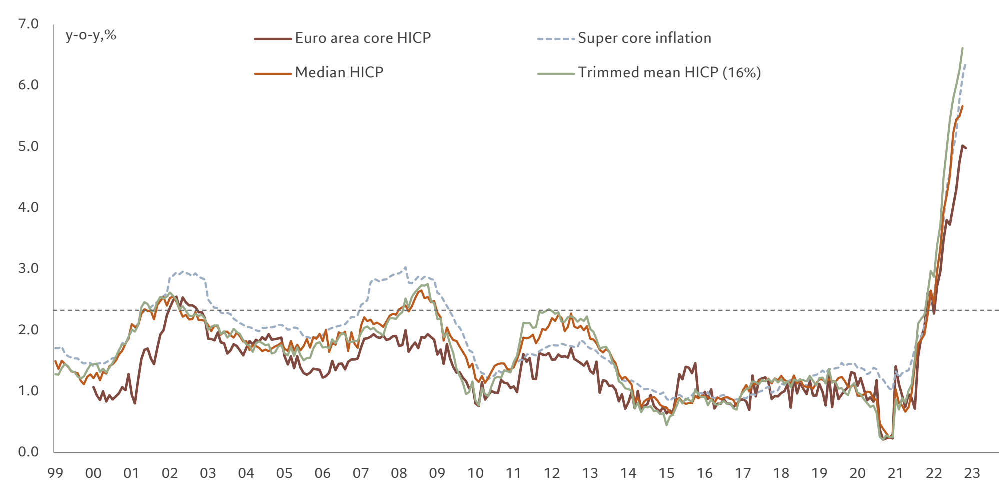
Methodological issues and the impact of various policy measures to consumer price indices are particularly difficult to assess.

Core inflation remained high at 5.0% y-o-y in November (see *chart 3*) and could hover around 4% for a while before easing very gradually in 2023. The easing of supply bottlenecks will help to moderate inflation, but rising wage pressure and the indirect effects of the commodity price shock should see price pressure remaining high in the coming quarters. In all, our central scenario is for euro area headline inflation to average 5.3% in 2023, down from 8.5% in 2022 and core inflation to average 3.5% in 2023 after 3.9% in 2022.

Chart 3: euro area underlying price measures



Source: PWM, Eurostat, 21 December 2022

ECB IS "IN FOR THE LONG GAME"

At its December meeting, the ECB hiked its policy rate by 50bp after two consecutive 75bp increases, bringing the deposit rate up to 2% and the refi rate to 2.5%. But more than the rate decision, the December meeting was all about communication. The ECB's governing council (GC) delivered a hawkish policy message. In particular, the GC signalled that "interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive". *Significantly* clearly signals a higher terminal rate. *Steady* suggests that the ECB believes further 50bp hikes may be appropriate for a while. During the Q&A session following the December GC meeting, Lagarde argued that the phrase meant it should be "obvious" to expect 50bp rate hikes for some time.

The ECB's new staff projections backed up the GC's hawkish language. In short, the ECB sees inflation staying high and the recession being brief and shallow. The new staff projections put headline inflation at end-2025 back at 2%—but the annual average remaining above target, with headline at 2.3% and core at 2.4%. To be sure, no one knows where inflation will be in three years, but it's the policy signal that matters and the signal is that more tightening is needed to bring inflation down.

It's hard to see the ECB's assessment changing very quickly. As a result, we have changed our scenario and we now see the ECB hiking the deposit rate by 50bp first

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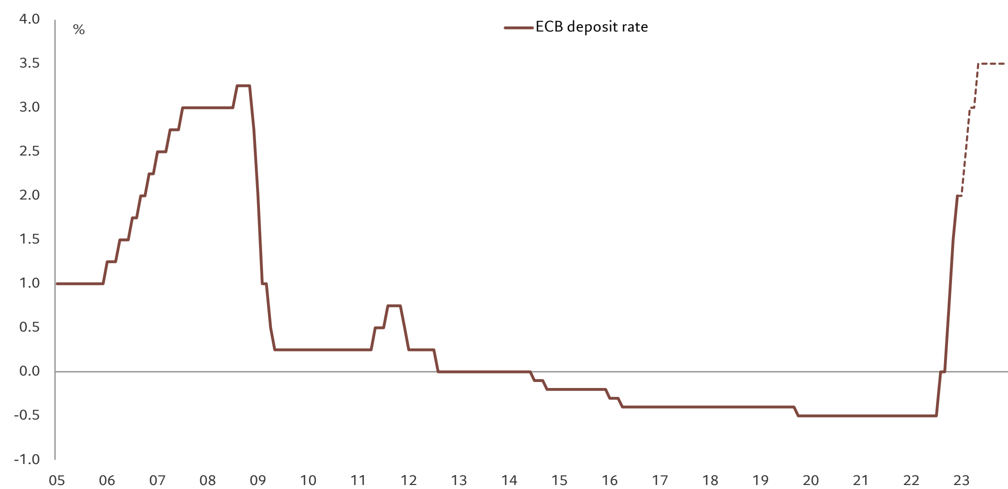
in February, 50bp again in March and May, before it marks a pause. This will bring the deposit rate up to 3.5% by the end of May 2023 (see *chart 4*). We think it will be difficult for the ECB to go further given the lagged impact of monetary tightening, particularly on countries with high debt and the likelihood that the US Federal Reserve will have paused its own rate hikes by then. Nonetheless, we think persistently high core inflation will preclude any rate cuts from the ECB until H2 2024.

In parallel with the latest rate hike this month, the ECB announced the general principles that will guide quantitative tightening (QT). The ECB will start QT in March 2023 by not reinvesting all the securities maturing under its Asset Purchase Programme (APP) (currently around EUR30 bn per month) at an initial monthly pace of EUR15 bn from March until the end of June. More details on the ECB's QT plans will be released at the next GC policy meeting in February.

Chart 4: ECB policy rate



Source: PWM CIO office & Macro Research, ECB, 21 December 2022

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