EURO AREA: ECONOMIC ACTIVITY

RAISING OUR GROWTH AND INFLATION FORECASTS FOR 2021

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SUMMARY

- Euro area GDP (flash estimate) rose by 2.0% q-o-q in Q2, much better than we expected (1.4%). High frequency data also point to strong activity at the start of Q3 despite the spread of the Delta variant.
- As a result, we have revised up our full-year GDP growth forecast for the euro area to 5.0% in 2021 (from 4.3%), but left unchanged our forecast for 2022 at 4.5%.
- Euro area HICP headline inflation rose to 2.2% y-o-y in July from 1.9% in June, the highest increase in almost three years and slightly above our estimate.
- The acceleration in price rises in July is only the beginning. Euro area HICP inflation is expected to accelerate strongly over the coming months due to a series of technical and one-off factors.
- Following recent upside surprises in inflation data and persistent bottlenecks we have revised our forecast for 2021 to 2.1% for headline inflation (from 1.7%) and 1.2% for core inflation (from 1.0%).
- Risks to our inflation forecasts are skewed to the upside, mainly because of supply-chain bottlenecks. How long these inflationary pressures persist will depend on how quickly supply comes back in line with demand. But we continue to expect the rise in inflation in H2 2021 to peter out and our 2022 forecast remains unchanged at 1.3% for headline inflation.

Q3 GDP growth to be even better than Q2

According to Eurostat's flash estimate, euro area GDP rose by 2.0% q-o-q (13.7% y-o-y; 8.3% q-o-q annualised) in Q2, after a 0.3% drop in Q1. This was above our estimate (1.4%) and leaves GDP 3.0% below its pre-crisis level (Q4 2019). The breakdown across expenditure components will not be published until 17 August but, according to details some countries have made available, household consumption was, unsurprisingly in light of re-openings, the main growth driver in Q2. Country wise, GDP growth in Spain (+2.8% q-o-q), Italy (+2.7%) and Portugal (+5.0%) beat our expectations, while data were in line with our expectations in Germany (+1.5%) and France (+0.9%). The divergence between countries mainly reflects differences in the timing of reopening and exposure to manufacturing bottlenecks.

Looking ahead, **we expect Q3 growth to be even better than Q2 for the euro area**. Survey data published so far point to a strong start to Q3 as covid-sensitive services catch up with sectors that have already rebounded. Meanwhile, even if held back by bottlenecks and input shortages, manufacturing activity remains solid. **Growth momentum should slow in Q4 but remain firm**, given supportive monetary and fiscal policies and the gradual unwinding of household savings.

Following better-than-expected GDP numbers in the periphery and strong high frequency data (July) despite the spread of the Delta, **we have raised our full-year GDP growth forecast for the euro area to 5.0% in 2021** (from 4.3%), **but we have left unchanged our forecast for 2022 at 4.5%**.

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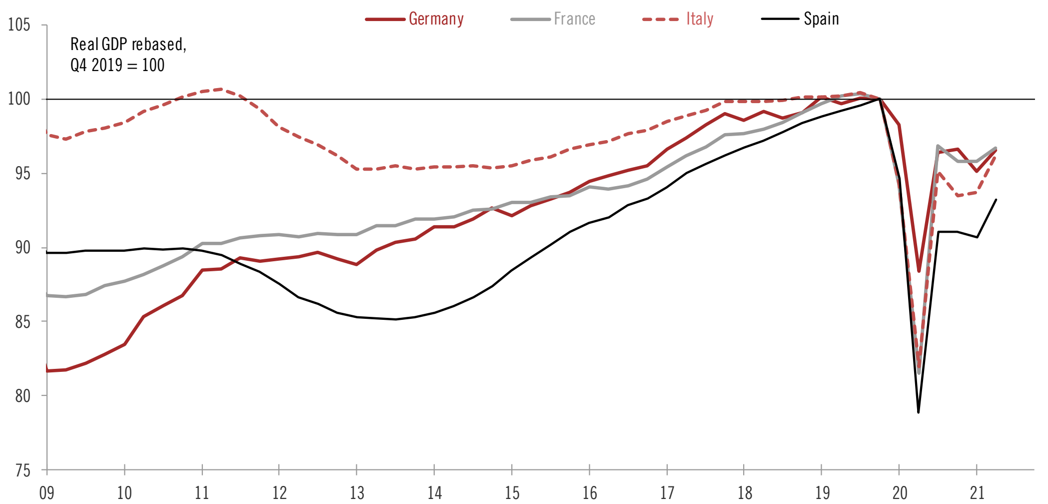
The growth outlook remains broadly balanced between upside and downside risks. On the upside, there is potential to see industrial output catching up with orders. The question is how quickly supply constraints ease. On the downside, the spread of the Delta variant remains a source of concern. So far, however, relatively few new restrictions have been imposed and recent news from early Delta hotspots (Spain, Portugal) have been encouraging. Our baseline assumption is that minor restrictions combined with vaccinations will be enough to flatten the infection curve.

There is also some uncertainty regarding the strength of pent-up demand. Households have accumulated large savings, but it remains to be seen how much and how quickly they will spend in the coming months. Older households' financial situation suffered less than younger ones' during the pandemic, and their savings increased the most. But older households tend to have a lower marginal propensity to consume, potentially weakening the post-pandemic pent-up demand effect expected on consumer spending. Yet momentum may remain strong in areas such as housing, thanks to supportive financing conditions.

CHART 1: EURO AREA REAL GDP REBASED (Q4 2019 = 100)



Source: PWM - AA&MR, Eurostat, 05 August 2021

Inflation is expected to surge

Euro area HICP headline inflation (flash estimate) rose to 2.2% y-o-y in July from 1.9% in June, reaching its highest level in almost three years. But the core rate fell to 0.7% from 0.9% the previous month, affected by a disrupted 2020 summer sales season in France and Italy and the change in HICP weightings. Both factors offset the positive base effect from the reversal of the German VAT cut.

The **acceleration in price rises in July is only the beginning. Euro area HICP inflation is expected to accelerate strongly over the coming months** due to a series of technical and one-off factors:

(1) The base effect resulting from the reversal of the H2 20 VAT rate cut in Germany. This reversal will push annual HICP inflation higher in H2 21 there and in the broader euro area. This effect is likely to fade in Q1 2022;

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(2) Price normalisation in areas like hospitality, travel and leisure services that were worst hit by Covid restrictions;

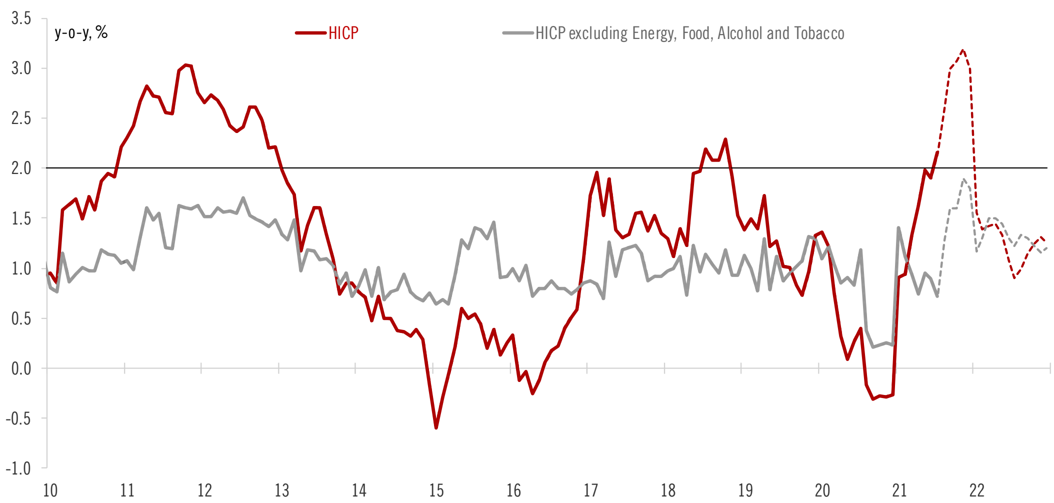
(3) Supply-chain bottlenecks; and

(4) Strong energy and commodity prices.

In light of recent upside surprises in inflation data and persistent bottlenecks **we have revised our inflation forecast for 2021 as a whole to 2.1% for headline inflation** (up from our previous forecast of 1.7%) and 1.2% for core inflation (up from 1.0%). **Risks to these forecasts are skewed to the upside**, mainly because of supply-chain bottlenecks. How long these inflationary pressures persist will depend on how quickly supply comes back in line with demand, but **we expect euro area headline inflation to peak in November at above 3% y-o-y**. **Expecting the leap in inflation in H2 2021 to be transitory, our 2022 forecasts remain unchanged at 1.3% for headline inflation**. Developments in employment will be important to monitor. Signs of increasing tightness in labour markets could determine whether the temporary rise in prices we are seeing turns into something more permanent.

We believe the European Central Bank will look though strong HICP prints in the coming months. The bank's hawks will probably become louder, but its new forward guidance issued in July means the bar for a rate hike has been raised. The focus on the ECB governing council meeting in September will be on what the central bank's new strategy means for asset purchases and targeted long-term refinancing operations (TLTROs) (see our latest note here).

CHART 2: EURO AREA HICP INFLATION



Source: PWM - AA&MR, Eurostat, 05 August 2021

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