ZURICH

Topical Thoughts
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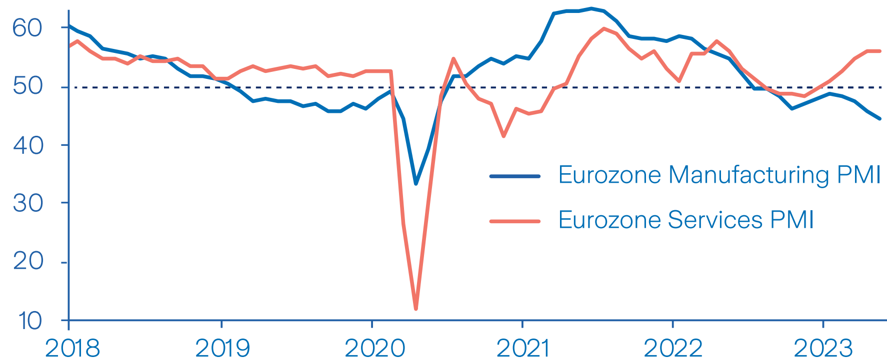
The Eurozone's two speed economy is likely to eventually falter

The Eurozone is experiencing a 'two-speed economy' at the moment. Activity in the service sector is decent as record low unemployment and falling energy prices support household spending.

However, manufacturing activity is weak. This is a concern as the manufacturing sector, even though it is smaller, often leads the rest of the economy. Indeed, we expect weak growth in the Eurozone for the rest of this year at best. Downside risks to our view depend upon the severity and timing of the recession in the US, which we still expect at some point this year, and also upon how recent banking and financial market stresses play out over the next few months.

Eurozone Services and Manufacturing PMIs diverge



Source: Bloomberg

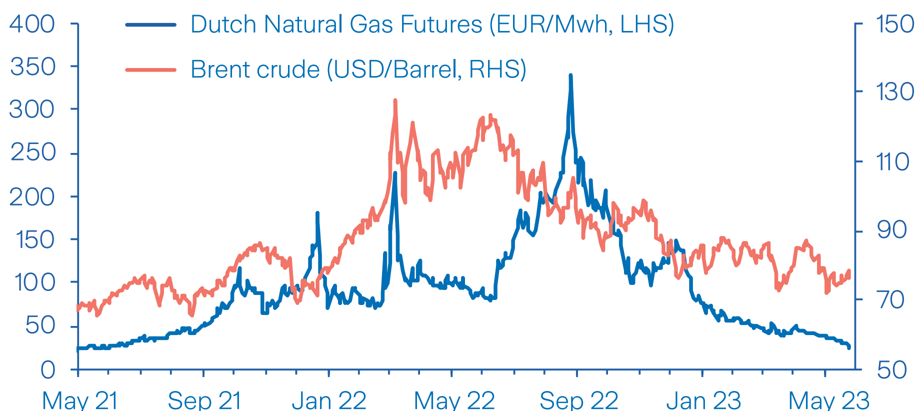
On a more positive note and looking further ahead, there have been substantial reforms over the past few years to the Eurozone's economic architecture that have made the single-currency area more resilient to shocks going forward. In particular, there is greater fiscal coordination and more recently an increased emphasis on ensuring energy independence. In this topical we delve into both the short-term challenges and medium-term opportunities for the region from a macro-economic perspective.

Front cover image source: iStock

Recession averted but the economy is still fragile

Despite the Russian invasion of Ukraine last year and the associated energy crisis, the latest data we have show that the Eurozone managed to avert a technical recession (defined as two successive quarters of economic contraction) over the winter months, mainly because the winter weather was exceptionally mild. Nevertheless, growth was weak around the turn of the year. Eurozone GDP was flat in Q4 2022 at 0.0% QoQ (1.8% YoY), and in Q1 2023 only grew by a meagre 0.1% QoQ (1.3% YoY). What's more, these figures could still be revised down in subsequent statistical releases by the European Commission's statistical agency, Eurostat. This was the case at the national level in Germany, for example, where growth in Q1 2023 was recently revised down from flat to minus 0.3% QoQ. Nevertheless, unless the Eurozone GDP data is revised down sharply in subsequent releases it looks like the region did manage to avoid a technical recession.

European natural gas prices fall back sharply



Source: Bloomberg

What helped enormously in avoiding a recession was that the Winter of 2022/23 was Europe's joint-second warmest winter on record, according to the EU's climate monitoring group, the Copernicus Climate Change Service (see Second warmest winter on record in Europe | Copernicus). The ability to source natural gas from other regions outside of Russia and the extremely mild winter weather meant that in the end there was no need for rationing gas in Europe as had been widely feared. This could have involved the closing of factories and have led to a sharp drop in output and a severe recession. Instead, natural gas prices fell back sharply and in Q1 2023 business confidence improved and the Eurozone economy grew slightly. The early and successful reopening of China's economy around the turn of the year following almost three years of Covid lockdown as well as resilience of the US economy also helped save the Eurozone from a more severe downturn at the turn of the year.

Next winter should also be manageable

The exceptionally mild 2022/23 Winter means the outlook for Winter 2023/24 is also more positive from an energy supply perspective than could have been feared a few months ago. Natural gas reserve levels across Europe are much higher than they would normally be at this time of year and therefore it should be possible to get through the next winter as well without the need for gas rationing, unless perhaps the winter weather is exceptionally cold this time around. Beyond this, we think that energy independence from Russia will have been achieved and that there will no longer be much risk of gas rationing.

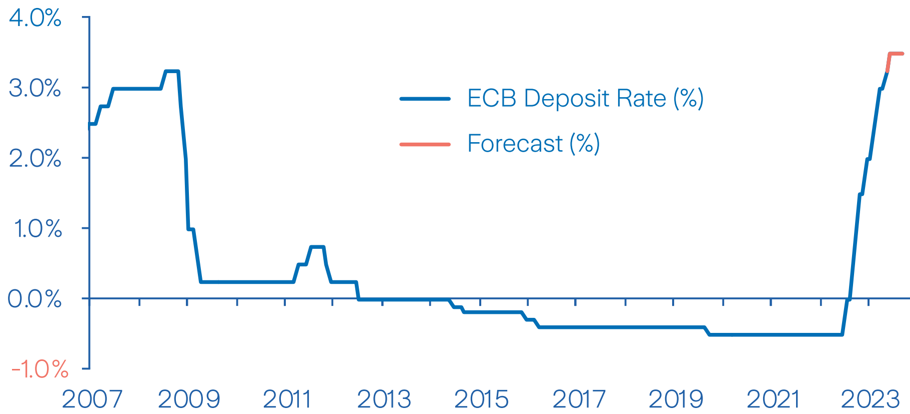
However, despite a bounce back in business confidence and activity in Q1 in most Eurozone countries, the near-term outlook for the region remains fragile, with growth likely to be soft over the course of most of 2023 and the economy operating not far from stagnation. The Eurozone remains exposed to a recession in the US that we still expect later this year even though the US economy has shown resilience so far. In addition, the lagged effect of aggressive monetary tightening in both Europe and the US has yet to show its full effect in terms of acting as a break on economic activity.

Indeed, although our base case is just for very weak growth or stagnation the rest of this year, Eurozone growth could still turn negative later this year depending upon how severe the downturn in the US is (at the moment we are only expecting a mild or moderate US recession) as well as how stresses in the banking system play out over the next few months in both the US and Eurozone. Equally, should the US avoid recession and/or current banking stresses diminish, then the Eurozone could see somewhat stronger growth this year than our current base case projection.

The ECB continues to tighten monetary policy and will be reluctant to cut rates

However, one significant concern we have is that the central banks of developed markets are continuing to tighten monetary policy and will be unlikely to loosen policy until and unless economic conditions get significantly worse because they are concerned about high inflation. For example, in the Eurozone the ECB has been raising interest rates aggressively since mid-2022. In early May this year it raised policy rates by a further 25bps, bringing its key policy rate, the deposit rate, to 3.25%. Admittedly, this represented a step down from the 50bp increments of rate increases at the last few meetings, but ECB President Christine Lagarde indicated that the ECB was expecting to increase interest rates further saying that, *'We are on a journey and we are not pausing.'* The central bank also announced that it would end reinvestments from its Asset Purchase Programme (APP) completely as of July 2023, representing an increase in the pace of quantitative tightening (QT).

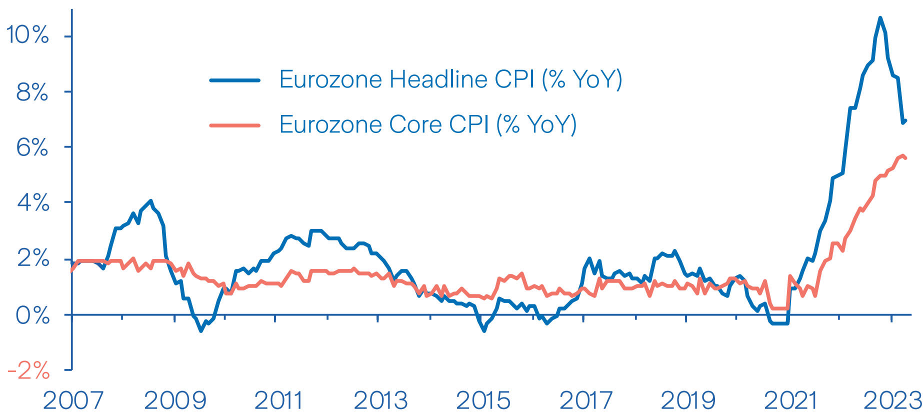
The ECB raises rates aggressively



Source: Bloomberg, ZIG Forecast

From the ECB's perspective, inflation remains uncomfortably high. Although headline inflation peaked in October 2022 at 10.7% YoY and is currently around 7% YoY as of the latest reading for April 2023, it is still elevated. In addition, core inflation is also extremely high at 5.6%. Wage deals are also continuing to come in on the generous side across Europe, including countries that have previously shown significant wage restraint such as Germany. We do expect Eurozone headline inflation to continue falling sharply. However, core inflation has been, and we expect will continue to be, much more sticky, especially given the recent generous wage deals we have seen.

Headline inflation falls but core is sticky



Source: Bloomberg

This is an important part of the reason why the ECB has maintained such a hawkish stance recently, and why it continues to tighten monetary policy even though this will eventually weigh on growth. The ECB will face a difficult balancing act in the coming months in trying to further tighten monetary policy without slowing down the economy too abruptly or creating additional financial market stress. We expect that the ECB will still having a tightening bias going forward, and think it will hike by 25bps at the next monetary policy meeting in June. Furthermore, even when the ECB stops hiking rates, we think it will then be reluctant to consider cutting rates even in the face of weak growth because of concerns about elevated inflation.

Lending surveys point to weaker growth

Monetary tightening and recent banking market stresses already appear to be having a dampening effect on activity. The latest ECB bank lending survey for Q1 2023 showed that credit standards to firms remained extremely tight and that demand for loans from enterprises have fallen sharply to levels close to those last seen during the Global Financial Crisis. Worryingly, this survey tends to be useful as a leading indicator of the economy.

Overall, with ECB monetary policy well into restrictive territory and likely to remain tight even when it does eventually stop hiking, we expect that this will weigh on growth further out in 2023 as the lagged effects of monetary tightening affect the economy. At best, we expect stagnation or weak growth for the Eurozone, especially in H2 2023, and then a modest recovery in 2024 to around a trend-like pace of growth.

Longer-term reasons for optimism

Looking further out, however, there are also reasons for optimism. The architecture of the Eurozone economy is stronger than it was a few years ago, making it more resilient to shocks. Over the past few years there have been various structural reforms that have made the region stronger from an economic point of view. The Eurozone debt crisis (2011-15) led to former ECB President Mario Draghi's famous *'Whatever it takes'* speech in 2012 when the ECB effectively committed to act as a backstop for the government bond market and buyer of last resort. This commitment was recently augmented by the ECB's Transmission Protection Instrument (TPI) announced last year when the ECB started raising rates. The TPI is designed to *'counter unwarranted, disorderly market dynamics'* and by implication a large widening in periphery government bond spreads by allowing the ECB to buy government bonds.

The COVID-19 Pandemic led to significant structural reforms on the fiscal side. The EUR 850bn NextGeneration EU (NGEU) fund was launched, and the EU was allowed to borrow substantial amounts and raise revenue at a central level for the first time. This represented a partial mutualisation of Eurozone government debts, and the ongoing fiscal stimulus of the NGEU spending until 2026 at least should support growth over the next few years. Russia's invasion of Ukraine has massively accelerated the push towards energy independence as well as the green transition. Finally, exiting from negative ECB policy rates is also a long-term positive for the region as we have long regarded negative policy rates as counter-productive and distortionary to the financial system. In conclusion, the result of these various shocks is that the Eurozone has become more closely integrated economically and its institutions more robust and this is a long-term positive for the region.

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