Euro Area Viewpoint

Forecast update: at least the autumn leaves are colourful

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Economics
Euro Area

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Same phenomena, stronger effects

We adjust our forecast today – those who missed the customary "back to school" forecast change didn't have to wait long. The themes are the same, just intensified, again. Long story short: the energy shock and policy tightening create very protracted growth weakness with almost no quarterly growth until spring 2024. That cannot help medium-term underlying inflation in an economy that never overheated. Recent oil price moves add to headline inflation now, but leave undershooting 2% part of our base case for 2025. That leaves us a little nervous on the ECB. We stick to our call that they're done with rate hikes, but equally that the first cut won't come before Jun-24. Although policy is already very restrictive, we see asymmetric risks of even tighter policy for even longer, but on the flipside, the risk of a faster than one-per-quarter cutting cycle, when it finally starts.

Growth: you don't need a recession to feel uncomfortable

Our Euro area GDP growth forecasts move to 0.5% in 2023 and 2024 (-10bp and -20bp, respectively), reflecting small cuts through autumn and winter with quarterly growth of 0-0.1% (-10bp on average vs prior forecasts). It's only in 2H24 – when policy becomes a little less tight and the impact of the energy shock starts to lose its grip – that growth will start to recover again. But 1.3% in 2025 is still a very tame "bounce-back" after two years of anaemic below-potential growth, really.

The sequence of growth weakness varies slightly within the Euro area. Today's forecast change concentrates on 3Q23-1Q24 and on core countries, Germany in particular. It's more a reflection of a bigger and longer hit from the energy crisis – ie, an extrapolation of the unexpected extra weakness in 1H23 to the rest of the year. Foreign demand plays second fiddle, still, especially as China growth past the trough and US growth slowing somewhat in our colleagues' forecasts should net out from a Euro area perspective. More country details below.

We move away from Bloomberg consensus (now at 0.5/0.8/1.5% for 2023/24/25), again. We continue to think consensus did and somewhat still does underestimate the persistence of the drag from Covid and the energy shock (never mind the policy tightening on top of that).

The risk balance is still tilted to the downside. Perhaps we are overestimating the consumer resilience in parts of the bloc or underestimating the drag from the construction/real estate sector on the back of policy tightening, for example. Or underestimating the speed at which unspectacular and highly uncertain demand prospects can weigh heavily on capex, like they did in the pre-Covid years, this time paired with fiscal and especially monetary policy tightening. The risk of non-linearities unfolding from the sequence of big shocks over the past few years, topped up with considerable policy tightening is high.

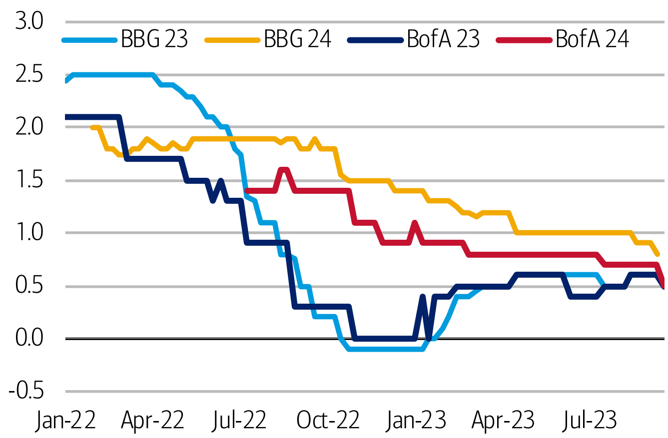
Inflation: higher oil vs lower food prices and disinflation in core

We also update our inflation forecast. The recent rise in oil prices – even if partially offset by lower food prices – pulls our headline forecast to 5.7% this year and 2.7% next (+20bp each) but leaves 2025 unchanged at 1.5%. The impact on core inflation is negligible: our 5.0%, 2.6% and 1.8% forecasts for 2023-25 remain unchanged.

Our headline forecast is now in line with consensus for this year and next, which, arguably, doesn't quite reflect the most recent moves in oil prices just yet.

Where we continue to differ from consensus is 2025 – we stick to our view that both headline and core will be back below the 2% inflation target, while consensus views headline at 2.1% still. Anaemic growth for two years following a still incomplete Covid recovery and very restrictive policy rates aren't the right mix to generate endogenous inflation above target.

Exhibit 1: Euro area GDP growth forecasts vs consensus
2023 growth is largely done now, but 2024 prospects are deteriorating, still



Source: Bloomberg, BofA Global Research

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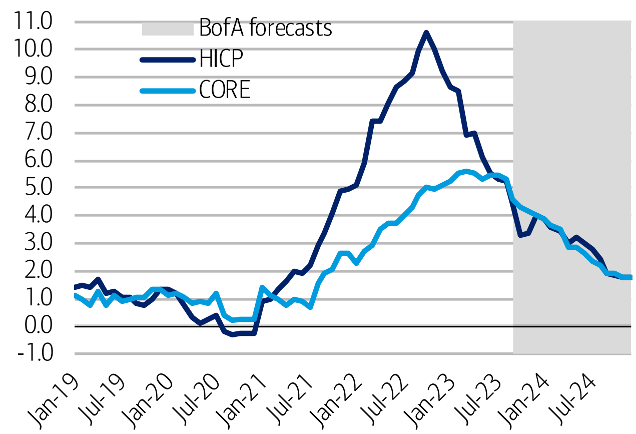
Exhibit 2: Euro area headline and core inflation forecasts
We still see inflation fall below 2% in late-24



Source: Eurostat, BofA Global Research

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ECB: no change to call, but risks are asymmetric

In spite of higher headline inflation forecasts, we think the ECB is done with hikes now that rates are at an all-time high for the institution. But we also still think that June 2024 is the earliest we should expect a hike. And we continue to see asymmetric risks for higher rates and/or a longer hold than an earlier cut – this is a possibility markets will have to entertain.

That said, a deposit rate at 4% is very deep into restrictive territory for the Euro area. The real economy has a lot to chew on with the protracted energy shock, severe monetary tightening, and fiscal policy turning more restrictive, too. In some countries, some Covid support is now reversing as repayments of state-backed start. The risk of stronger-than-expected synergies (or new shocks) is still prominent. That doesn't mean cuts could come earlier, but rather that when the cutting cycle eventually starts, it might go at a faster clip than one 25bp cut per quarter.

Country details: the news is concentrated in the core

Germany: it's tough to grow without any help

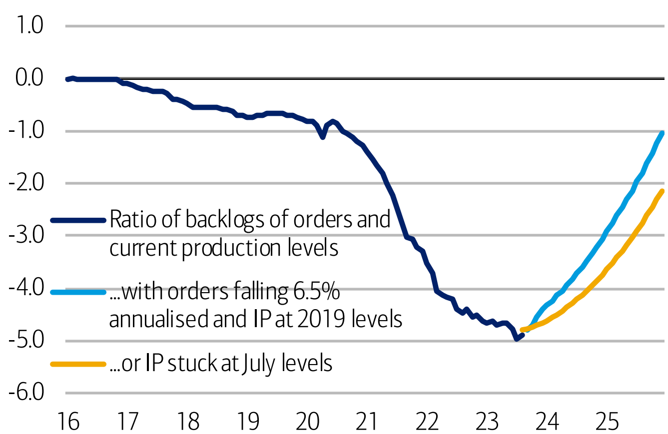
Our forecast stays at -0.4% for 2023 (stronger carryovers from 1Q23 GDP revisions compensate for the cuts to 2H23 quarterly growth forecasts to -0.1% qoq on average). But 2024 drops to 0.3% (-40bp). Although growth is likely to look similar at the Euro area and German levels again in 2025, Germany will have underperformed the bloc's average by a cumulative 4.8% since 2019. We have long been German bears, especially in comparison to neighbouring France, and don't think there is any relief in the pipeline.

Germany has slipped into a mild "technical" recession with two consecutive quarterly contractions last winter. We now pencil-in another contraction in 3Q23 (-0.2% qoq) and zero growth in 4Q23, with higher conviction in a mild contraction in the 2H23 average than the exact profile. This is a "benign" outcome compared with fears of a deep recession on energy supply shortage, but nonetheless bad news because it is still a significant deviation from the pre-war base case. And because temporary and structural forces are at play, we do not think we are done with growth challenges for a while.

Industrial production carryovers at -2.3ppt for 3Q look very weak after July, but August car production numbers suggest some of that will be offset. Beyond that, we expect sector activity to continue to move sideways, essentially. Yes, demand (ie orders) have weakened considerably over the past year, but are starting to show signs of stabilisation in energy-intensive sectors. But current backlogs are still high. Even a sustained downward trend in demand could probably be smoothed over for quite some time. In Exhibit 3 we show the gap between cumulated production and cumulated orders (since 2015) divided by current production levels as a proxy under the assumption of a sustained downward trend in orders of 6.5% from now (equivalent to the 2018/19 trend) with production stuck at July levels or improving c 4% to 2019 levels again by year-end and staying there after. Even under these relatively tough assumptions, it would take until late 2025 for backlogs to return to pre-Covid levels (assuming no cancellations in between, of course). To be clear, what may seem a benign assumption given the underlying structural challenges (the energy mix, high external demand exposure, especially to China, or a concentration of activity in the car industry) is still very tough for the economy, given the sector accounts for almost a quarter of total value added.

Exhibit 3: Backlog proxy: (cum. IP – cum. orders)/ monthly IP

Backlogs are very high and should help smooth production for a while



Source: Destatis, BofA Global Research

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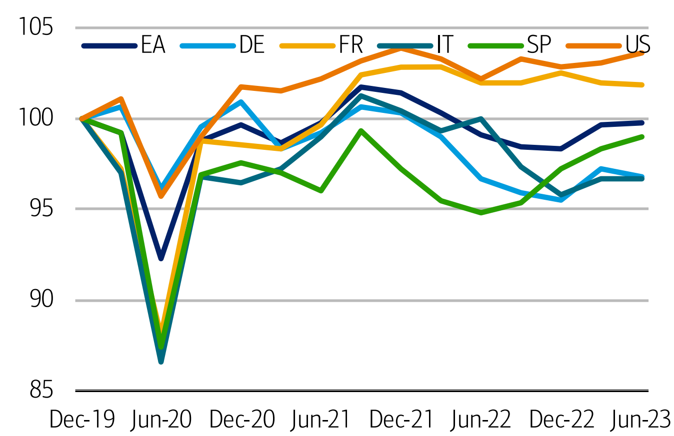
Exhibit 4: Real compensation level (4Q19=100)

German consumers suffered a bigger energy crisis hit than most peers



Source: Eurostat, BEA, BofA Global Research

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Domestic demand is under a lot of pressure, too. The drag from high energy inflation paired with persistent energy supply uncertainty is real. Consumption contracted a cumulative 1.3% last winter, and we don't expect an improvement before real income grows again slightly next year. Gross savings rates remain stubbornly high at the expense of consumption, probably reflecting precautionary motives. Real compensation underperformed that of peers, and wage growth excl one-offs has only normalised to 3%. The use of short-time work schemes is declining, but 157K "effective" short-time workers in Feb-23 (latest official data) is still more than five times as many as in Feb-19, for instance. That is slack in the economy, and part of the reason why we still don't see a wage-inflation spiral. But as disinflation continues – we expect inflation at 6.5%, 3.4% and 2.0% in 2023-25 – real income should stabilise and eventually grow, helping consumption improve somewhat in 2024.

Capex, too, is likely to be anaemic. PMI-implied manufacturing margins have normalised fast from very comfortable levels a year ago still. Uncertainty, weak demand prospects and higher funding costs add to the mix. The construction sector has also turned: Ifo reports more than 20% of surveyed companies reporting project cancellations (highest proportion since the start of the survey in 1991) and 44% an insufficiency of orders. Shortage of labour in the sector seems to be correcting fast, too. Capex is, arguably, where risks to our forecast in 2024 are particularly prominent.

We doubt decisive policy action can be taken to change the economic outlook. The constitutional debt brake still bites. And while the use of one-off envelopes for multiple years in the form of off-balance sheet vehicles blurs the fiscal impulse to the economy (and funding needs), past growth performance would suggest either funds available on paper are not deployed in practice, or that the plethora of measures resulting from political compromise has been rather ineffective in economic terms. Intra-government tensions are high, and polls show rising support for opposition parties, right-wing populist Alternative fuer Deutschland, in particular. The upcoming state elections in Bavaria and Hesse (8 Oct) could create noise. The next federal election is only in 2026, but with political capital constraints and tensions elevated, a swift and decisive rethink of the current and future policy stance that could help the economic outlook is a tail risk, leaving the economy to its own endogenous forces (or the lack thereof).

France: at least growth is looking smooth

France is one of the brighter spots in the Euro area. A particularly strong 2Q23 GDP print triggers an upgrade to 2023 growth forecasts to 0.9%, followed by 0.8% in 2024 (-10bp) and 1.3% in 2025 (unch). ECB policy tightening will slow French growth, too. But the starting point is more comfortable than elsewhere, which matters for the trajectory. Preliminary budget plans for next year (-4.4% of GDP in 2024 after -4.9% in 2023) would imply only a mild tightening of the fiscal stance, thereby lowering the risk of non-linearities from combined monetary and fiscal policy in the economy.

We expect inflation at 5.9%, 2.9% and 1.6% in 2023-25. Wholesale prices for gas and electricity have normalised, so the end of the gas price cap this year should not matter for inflation. And once next February's electricity hike of 10-20% flagged by the regulator (we pencilled-in 15% a while ago) is through, further upside should be limited here, too. With headline disinflation starting, and the economy growing at a decent but not extraordinary pace, we equally think this year's wage growth improvement will prove temporary. But there is perhaps a bit more risk of stickier wage growth in France than elsewhere in the region, at this stage.

Italy: slowing growth, fiscal headaches

We remain below consensus on growth for this year and, especially, for next year. After this week's mark-to-market, our GDP growth forecast stands at 0.7% for 2023 and 0.4% in 2024 (consensus is at 0.8%/0.7%). We shaved 10bp off both years: more subdued consumer dynamics, slower NGEU absorption and clear industrial headwinds (Italy's industry is closely linked to Germany) will likely keep growth very close to zero in the coming quarters. Monetary transmission is quite clear in Italian data – with rates at restrictive levels for several quarters, activity will be constrained. We think risks are fairly balanced around our base case at this stage. In 2025, we would expect growth to reaccelerate to somewhere slightly above 1%.

But, for Italy, all eyes will be on fiscal balances. There are several moving parts: 1) the government will present the 2024 draft fiscal plan next week, with near-zero space for manoeuvre – discussions with the European Commission will follow; 2) there is a lot of uncertainty on the costs of the "Superbonus" tax deductions and their statistical treatment – this may drive large swings in past/current/future deficits and also in capex macro data; 3) Italy's controversial ratification of the ESM (European Stability Mechanism) treaty will come to a parliamentary vote in October; and 4) the crucial negotiations among EU member states on fiscal rules need to reach a compromise in the coming months.

Giorgia Meloni's cabinet has been quite careful on the expenditure side so far. With the crucial negotiations ongoing in Brussels, a conflict with the EU institutions and other EU governments would certainly be very costly – a sensible outcome to the fiscal rules negotiation is key for Italy's outlook, as well as for this government's policy agenda. Some fiscal restraint remains the base case. But, with slowing growth (we will watch closely the growth assumptions in the new draft budget) and high uncertainty on the "Superbonus" budgetary/growth implications, the government finds itself with near-zero space for fiscal manoeuvre. Coalition members are getting nervous about the lack of funds to meet electoral promises ahead of next year's European election – increasing political volatility remains the main risk.

Spain: slowing but, still, outperforming

Our forecasts for Spain move little and, mostly, driven by data revisions. We now forecast GDP growth of 2.1% in 2023, 1.1% in 2024, and 1.5% in 2023. Lower energy prices, decent employment growth, improvements in the implementation of NGEU and the final leg of normalisation post reopening have contributed to stronger-than-expected growth. We expect growth to decelerate significantly in the second half of the year and throughout 2024 given the lagged impact of monetary policy but also, fiscal policy that should turn less supportive in 2024 and beyond.

Despite strong growth, internal demand has been suffering over the past few quarters - unsurprising given consumer headwinds. From here, there are cross-currents. The smaller real income squeeze driven by the moderation in energy prices should support an improvement in private consumption (we expect inflation of 4% in 2023, after 8.3% in 2022). At the same time, tighter monetary policy is likely to offset some of that improvement and contribute to weak capex trends. Delays in NGEU implementation, given the political impasse, could also slow growth further.

While we await government formation (or, likely, new elections), we reiterate what we have said before. Most of the challenges still facing the Spanish economy are likely to require agreements between the many different forces in the highly fragmented parliament. Fragmentation is the only certainty we have today on the outcome of the upcoming election. And agreements involving the main traditional parties remain elusive. Hence, vulnerabilities are likely to persist irrespective of the new government, leaving Spain exposed to sudden changes in sentiment in the context of higher interest rates, weak growth, a less supportive ECB balance sheet, large issuance needs, and still sizeable external debt.

Exhibit 5: Euro area economic forecasts
We see the ECB reaching a refi terminal of 4.50%.

		2021	2022	2023	2024	2025	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24
GDP	% qoq						0.1	0.1	0.0	0.1	0.1	0.2	0.3	0.3
	% qoq ann.						0.3	0.5	-0.1	0.2	0.3	1.0	1.0	1.3
	% yoy	**5.6**	**3.4**	**0.5**	**0.5**	**1.3**	1.1	0.5	0.1	0.2	0.3	0.4	0.6	0.9
Private Consumption	% qoq						0.0	0.0	0.1	0.1	0.2	0.3	0.3	0.3
	% yoy	**4.1**	**4.3**	**0.3**	**0.7**	**1.1**	1.4	0.2	-0.6	0.2	0.4	0.6	0.9	1.0
Government Consumption	% qoq						-0.6	0.2	0.2	0.2	0.2	0.3	0.2	0.2
	% yoy	**4.1**	**1.4**	**0.0**	**0.9**	**1.0**	-0.4	0.1	0.3	0.0	0.9	0.9	0.9	1.0
Investment	% qoq						0.3	0.3	0.2	0.1	0.0	0.2	0.3	0.4
	% yoy	**3.6**	**2.9**	**1.1**	**0.7**	**1.6**	1.9	1.3	0.6	0.9	0.6	0.5	0.6	0.9
Final Domestic Demand[1]	% qoq						0.0	0.1	0.1	0.1	0.2	0.2	0.3	0.3
	% yoy	**3.9**	**3.1**	**0.4**	**0.7**	**1.1**	1.0	0.4	-0.1	0.3	0.5	0.6	0.8	0.9
Net exports[1]	% qoq						0.6	-0.4	-0.1	0.0	0.1	0.0	0.1	0.1
	% yoy	**1.4**	**-0.1**	**0.4**	**0.0**	**0.3**	0.5	0.2	0.7	0.1	-0.5	0.0	0.1	0.3
Stockbuilding[1]	% qoq						-0.5	0.4	-0.1	0.0	-0.1	0.0	-0.1	0.0
	% yoy	**0.3**	**0.4**	**-0.3**	**-0.2**	**-0.1**	-0.4	-0.1	-0.5	-0.2	0.2	-0.3	-0.3	-0.3
Current Account Balance	EUR bn	**278**	**-149**	**147**	**209**	**219**	74	-36	35	75	55	-6	85	75
	% of GDP	**2.3**	**-1.1**	**1.1**	**1.4**	**1.5**	2.1	-1.0	1.0	2.1	1.5	-0.2	2.4	2.0

Exhibit 5: Euro area economic forecasts

We see the ECB reaching a refi terminal of 4.50%.

		2021	2022	2023	2024	2025	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24
Industrial production	% qoq						-0.3	-1.0	0.2	0.5	0.4	0.5	0.7	0.7
	% yoy	**8.8**	**2.1**	**-0.9**	**1.5**	**2.6**	0.1	-1.1	-2.1	-0.6	0.1	1.6	2.1	2.3
Unemployment rate[3]	%	**7.7**	**6.8**	**6.7**	**7.0**	**6.9**	6.6	6.6	6.7	6.7	7.0	7.0	7.0	6.9
CPI (harmonised) [4]	% qoq						0.4	1.6	0.6	0.9	0.4	1.1	-0.1	0.3
	% yoy	**2.6**	**8.4**	**5.7**	**2.7**	**1.5**	8.0	6.2	5.0	3.6	3.6	3.1	2.4	1.8
CPI (core) [4]	% qoq						0.6	2.4	0.5	0.6	0.1	1.5	-0.1	0.3
	% yoy	**1.5**	**3.9**	**5.0**	**2.6**	**1.8**	5.5	5.4	5.1	4.2	3.7	2.8	2.2	1.8
General govt balance	% of GDP	**-5.3**	**-3.6**	**-3.9**	**-3.0**	**-2.6**								
General govt debt	% of GDP	**95.5**	**91.6**	**90.0**	**89.7**	**88.3**								
Refinancing rate	%	**0.00**	**2.50**	**4.50**	**3.75**	**2.75**	3.50	4.00	4.50	4.50	4.50	4.25	4.00	3.75

Source: BofA Global Research, Notes: 1 Contribution to GDP growth 2 Excluding construction, sa, quarterly averages 3 Period averages 4 Period averages, quarterly change

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Exhibit 6: Euro area GDP and CPI forecasts

Euro area member states profiles

	GDP						HICP					
	2020	2021	2022.0	2023F	2024F	2025F	2020	2021	2022	2023	2024	2025
Euro area	-6.3	5.6	3.4	0.5	0.5	1.3	0.3	2.6	8.4	5.7	2.7	1.5
Austria	-6.5	4.7	4.9	0.1	0.4	1.3	1.4	2.8	8.6	7.6	3.6	2.4
Belgium	-5.4	6.3	3.2	0.9	0.6	1.2	0.4	3.2	10.3	2.8	3.4	1.9
Finland	-2.4	3.2	1.6	0.3	0.5	1.0	0.4	2.1	7.2	4.5	1.7	1.5
France	-7.7	6.4	2.5	0.9	0.8	1.3	0.5	2.1	5.9	5.9	2.9	1.6
Germany	-4.2	3.1	1.9	-0.4	0.3	1.3	0.4	3.2	8.6	6.5	3.4	2.0
Greece	-8.7	8.1	5.9	2.1	1.0	1.7	-1.3	0.6	9.3	4.2	1.9	1.7
Ireland	5.8	14.8	7.1	1.3	2.4	2.0	1.1	1.2	5.1	5.4	2.2	1.6
Italy	-9.0	7.0	3.8	0.7	0.4	1.2	-0.1	1.9	8.7	6.6	2.4	1.4
Netherlands	-3.9	6.2	4.4	0.3	0.3	1.6	1.1	2.8	11.6	4.9	3.3	1.6
Portugal	-8.3	5.5	6.7	2.2	1.1	1.5	-0.1	0.9	8.1	5.8	2.7	1.3
Spain	-11.3	5.5	5.5	2.1	1.1	1.5	-0.3	3.0	8.3	3.7	2.6	1.2

Source: Eurostat, BofA Global Research

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